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Meeting of the Federal Open Market Committee

March 29, 1988

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, March 29, 1988 at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Heller
Mr. Hoskins
Mr. Johnson
Mr. Kelley
Mr. Parry
Ms. Seger

Messrs. Guffey, Keehn, Melzer, and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Patrikis, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Broadus, J. Davis, R. Davis, Lindsey, Siegman, and Slifman, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Cross, Manager for Foreign Operations, System Open Market Account

3/29/88

- 2 -

Mr. Coyne, Assistant to the Board of Governors
Mr. Promisel, Senior Associate Director, Division of
International Finance, Board of Governors
Mr. Whitesell, Economist, Division of Monetary Affairs,
Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. Balbach, T. Davis, Lang, Rosenblum, and Scheld,
Senior Vice Presidents, Federal Reserve Banks of
St. Louis, Kansas City, Philadelphia, Dallas, and
Chicago, respectively

Messrs. Fieleke and Judd, Vice President, Federal Reserve
Banks of Boston and San Francisco

Ms. Rosenbaum and Mr. Weber, Research Officers, Federal
Reserve Banks of Atlanta and Minneapolis

Ms. Meulenydke, Manager, Federal Reserve Bank of New York

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March 29, 1988

CHAIRMAN GREENSPAN. I think that Governor Johnson is the titular, de facto, temporary chairman.

MR. JOHNSON. I'd like to nominate Chairman Greenspan, of course, as Chairman of the FOMC to kick this meeting off. So, I move Chairman Greenspan as Chairman of the FOMC.

MS. SEGER. I second that.

MR. JOHNSON. It looks like it's all done, Mr. Chairman.

CHAIRMAN GREENSPAN. Doesn't strike me as a democratic election! Would somebody like to move the Vice Chairman?

MR. JOHNSON. Yes, I also move President Corrigan as Vice Chairman of the FOMC.

CHAIRMAN GREENSPAN. No objection. I don't know when that game is in June.

VICE CHAIRMAN CORRIGAN. That's right. The Chairman is talking about a major international event we have coming up in June. We have a challenge of a softball game between the Bank of Japan and the Federal Reserve Bank of New York.

SPEAKER(?). We better beat them.

VICE CHAIRMAN CORRIGAN. Much is at stake.

SPEAKER(?). You're going to have a hard time.

MR. ANGELL. You are not authorized to play for the System; it's just restricted to New York?

SPEAKER(?). That's right.

SPEAKER(?). Are there implications for the exchange markets?

VICE CHAIRMAN CORRIGAN. You can wait for the outcome to see.

CHAIRMAN GREENSPAN. Will Mr. Bernard read the staff officer nominees?

MR. BERNARD.
Secretary and Economist, Donald L. Kohn
Assistant Secretary, Normand Bernard
Deputy Assistant Secretary, Rosemary Loney
General Counsel, Michael Bradfield
Deputy General Counsel, Ernest Patrikis
Economist, Michael J. Prell
Economist, Edwin M. Truman

Associate Economists from the Board:

David Lindsey;
Charles Seigman;
Thomas Simpson; and
Lawrence Slifman.

Associate Economists from the Federal Reserve Banks:

J. Alfred Broadus, proposed by President Black;
Jack Beebe, proposed by President Parry;
John Davis, proposed by President Hoskins;
Richard Davis, proposed by President Corrigan; and
Sheila Tschinkel, proposed by President Forrestal.

CHAIRMAN GREENSPAN. Can we have somebody move and second those officers?

VICE CHAIRMAN CORRIGAN. Move it.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. The next item is choice of the Federal Reserve Bank to execute transactions for the System Open Market Account. Would somebody like to make a nomination?

SPEAKER(?). I will move, sir.

CHAIRMAN GREENSPAN. You need to state a preference. Why don't we try New York?

SPEAKER(?). I'm going to: New York.

SPEAKER(?). Do they have a staff that can handle that primary--

CHAIRMAN GREENSPAN. That's their problem.

VICE CHAIRMAN CORRIGAN. Can I raise a point of order, Mr. Chairman?

CHAIRMAN GREENSPAN. By all means.

VICE CHAIRMAN CORRIGAN. Going back to the organizational meeting schedule, I wonder if it might not be well for the Committee to consider changing the organizational meeting from March to February. The rationale I have in mind is that it always strikes me as anomalous that the presidents who vote for the annual targets at the February meetings cease being the presidents who vote for the balance of the year. I just wonder if in the interest of consistency--

CHAIRMAN GREENSPAN. May I point out that a discussion of procedures is a later item on the agenda.

VICE CHAIRMAN CORRIGAN. Okay.

CHAIRMAN GREENSPAN. I think that that would be an appropriate item to bring up at that time. Why don't we do that? I have a motion. Do I have a second?

SPEAKER(?). I second it.

CHAIRMAN GREENSPAN. No objections? Now we can vote on the selection of the Manager for Domestic Operations and the Manager for Foreign Operations, System Open Market Account. The incumbents are currently, of course, Mr. Sternlight and Mr. Cross. Would somebody like to make any other nominations, and if not would somebody like to move, second or oppose?

SPEAKER(?). Move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. It is required that these nominees be acceptable to the Board of Directors of the Federal Reserve Bank of New York, which I assume will occur with the usual formality.

The next item is the Authorization for Domestic Open Market Operations. Is there any objection to renewing the authorization as it stands? If not, we can consider that to be done. We also need to renew the Foreign Currency Authorization, the Foreign Currency Directive, and the Procedural Instructions With Respect to Foreign Currency Operations. Any objection to renewing all three?

SPEAKER(?). None.

CHAIRMAN GREENSPAN. If not, consider it done. We have the same issue with respect to the Program for Security of FOMC information. Why don't you read the changes, Mr. Bernard?

MR. BERNARD. It involves just a very minor updating since there is no longer a staff director. As noted in the memorandum dated March 23, the new language for page 2, Section A.3 would read: Upon adoption, distribution of and access to the directives would be limited to Committee members, nonvoting Presidents, staff officials involved with the daily morning "call" from the Open Market Desk, the Secretariat, and the two Managers (or their substitutes).

CHAIRMAN GREENSPAN. Without objection, the authorization is renewed. Governor Johnson, I understand, is prepared to make a nomination with respect to a variety of appeals authority.

MR. JOHNSON. Yes, I'd like to move that Governor Angell be the FOMC member in charge of [Freedom of Information Act] appeals and that Governor Seger be the alternate.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Any questions on the examination report of the System Open Market Account? Would somebody move acceptance?

MS. SEGER. I'll move it.

CHAIRMAN GREENSPAN. Second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. No objection. Now we are finally up to the minutes. Without objection. Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Any questions for Mr. Cross?

MR. JOHNSON. Sam, what did you say again about the currency after the end of the [Japanese] fiscal year?

MR. CROSS. There has been a great deal of concern that, particularly during March, the yen has been held down artificially and the dollar has been held up artificially because of concerns about the Japanese institutions who must complete their bookkeeping at the end of March. Much of this has to do with the Japanese insurance companies who, according to the rules that they follow, have to adjust the value of their total holdings of foreign and dollar securities if the dollar falls by 15 percent, on average, during March from the level of a year ago. This would mean a very substantial recalculation of the books of these insurance companies. And there is a widespread view that that possibility, plus traditional Japanese window-dressing operations, which are very important, have caused the Japanese to take steps to avoid the pressure to cause the yen to rise--to hold the dollar up against the yen, in effect, until after this March 31st date. So the question now is whether, after the end of March, there will be some tendency and intention, on behalf of the Japanese particularly, to shift out of dollars or to cease the operations which the market thinks are holding the dollar up, or to take other steps.

MR. JOHNSON. What kind of appreciation would it take for the rest of the month, or late in the month, to produce an average of the month below 126 [yen per dollar]?

MR. CROSS. It would have to go down pretty low at this point. We recalculate this every day; we just don't have the latest update. Yesterday it was something like 121 or 122. But one argument made in the market about some of the pressure recently is that this is less of a concern now that we've gotten close enough to the end of the fiscal year. There is less of a reason for the yen to be held down.

MR. JOHNSON. The Japanese really haven't been intervening on the scale that they had before, right?

MR. CROSS. They have not been intervening in very heavy amounts, but they have been taking related steps. There was a statement by the head of the Japanese insurance groups last night, saying that he didn't expect a lot of sell-off of dollar securities after the end of the fiscal year. I assume that the Bank of Japan put him up to that. There have been other steps that they have taken to contain some of these pressures.

MR. TRUMAN. The question is whether institutions themselves would be supporting the dollar in this period, since it also affects the institutions--not just the ones that are accepting the 15% rule but the ones that are on a mark-to-market basis [unintelligible] particular interest.

MR. CROSS. Yes, I think that--

MR. TRUMAN. It may affect the general institutions a lot more across the board.

MR. JOHNSON. It's going to be mark-to-market for all of them after the fiscal year has ended, right?

MR. CROSS. That's right, but--

MR. JOHNSON. And there will still be a strong incentive for them not to want the exchange rate [unintelligible] right?

MR. CROSS. No, but the year-end is particularly important. And this happens even when we don't face the kind of exchange market situations that we face now. The Japanese are very conscious of these year-end figures, and toward the end of the fiscal year there are a lot of pressures back and forth, reflecting that concern. So this is not a new phenomenon.

MR. JOHNSON. I have one more question. Maybe I've been reading too much into this, but it did run on the wires here that the Bank of Japan has decided to tighten up some. They made an announcement that they were going to tighten up on money and bank reserves. At least the way that I read it over the wires several times was that there had been some sort of announcement of slight tightening for short-term conditions in Japan. It seems kind of strange that they would do something like that.

MR. CROSS. Well, they've been telling us that they need some slight pressures--again, because of those fiscal year-end kinds of problems. But we have not gotten from them evidence that they are tightening beyond that.

MR. TRUMAN. This is an impressive movement with a [unintelligible] for the large banks.

SPEAKER(?). Right.

MR. TRUMAN. In fact, they have been progressively tightening over the last several months and this [unintelligible] they've obviously done their [unintelligible] this is one more out of about 3 or 4 now this seems to have been [unintelligible].

MR. JOHNSON. I understand what they are doing. I'm just saying that the market seems--

MR. BOEHNE. It seems to me that the larger issue, aside from things like the Japanese fiscal year, relates to times when we see these exchange relationships coming unglued. Are we dealing with something that we can put a little more glue in there through intervention and move forward, or is it something more basic--like changes in economic growth or inflation or domestic economic policies or that the adjustment process isn't moving as fast as it should. I would think that, while it is an impossible question to answer, you have to ask it nonetheless when you are talking about what the appropriate response is going to be. If we think that it just needs some more glue, then we can achieve some good through intervention; if

we think that it is more basic than that, then by intervening we sort of throw good money after bad. It may mean that we have to seek a new exchange rate alignment, or it may take a more fundamental change in U.S. domestic policy. As I say, it is a question that there is no obvious or easy answer to; but it seems to me that we have to ask it rather than continue intervening willy-nilly and hoping that will solve the problem. I'm not against the intervention--it just seems to me that we have to think the thing through a little more carefully than to just say "Well, let's intervene and see what happens."

CHAIRMAN GREENSPAN. I think that you're raising an important question that has no good answer. But an interesting issue is whether there is an answer to a secondary question: Can intervention even remotely succeed on an incremental basis? In other words, do we make much progress by small interventions, which can't have any effect or are perceived to be ineffectual and may even be counterproductive? Or, if we have the choice, if the rate has to be sustained, do we choose to intervene in amounts that do affect the market? I don't know how [unintelligible] reads the experience in the last six months, but it strikes me that the only times that I was concerned about the intervention were when [unintelligible] and it didn't seem to have any effect as we watched the monies being spent. But I know when [unintelligible] hit the markets heavy and hit them also on the way up, I thought we received [unintelligible] response. We may not be able to answer the first question, and I don't think that we will ever be able to answer that one; but my own question is whether or not we should at least be focusing on the more discontinuous intervention--whether you're in or out--not this dribble effect.

MR. BOEHNE. I think that's a good point. I guess mine goes even beyond that. It may mean that there isn't much that we can do if there is a fundamental misalignment here. Or if we're going to do something, it may take this more forceful intervention coupled with a noticeable change in monetary policy. I'm getting ahead of the discussion but I think that--

CHAIRMAN GREENSPAN. That's a crucial issue. I don't think anybody denies that monetary policy is effective--

VICE CHAIRMAN CORRIGAN. I think that that is right in terms of the real question, but I'm not so sure that the question is unanswerable, in the ultimate sense of the word. I find it compelling to ask myself a question: What are the implications of a significant further decline in the dollar from where we are now? I think you have to think it through on the trade side and on the financial side. In my view, the problem on the trade side is that the current forecast may embody a speed of adjustment that is about as fast as we can hope to achieve; indeed, it seems to me that it may border on the edge of being dangerously fast, in the context of being inflationary. So, I don't see that there is a whole lot to be gained in the foreseeable future on the trade side from a further decline in the dollar. Then, I ask myself the question: What does it imply on the financial side? And by financial side, of course, I mean our capacity to finance a \$140 billion current account deficit this year. And that question, it seems to me, is more difficult. I can't quantify how much more difficult, but I think the algebraic sign is clear enough. So, where I come out, without being able to be precise, is that I see a clear risk on the side of a further depreciation of the dollar and I see

very little to be gained by a further depreciation of the dollar. I don't know what it gets us.

CHAIRMAN GREENSPAN. But it's a very interesting analytical question as to whether one can make the judgment you're making--in other words, it really gets to the crucial question of what's the elasticity of supply of our system in the manufacturing sector and how close we are [to full capacity]. I think that it will be helpful later if both Messrs. Prell and Truman could address this issue as to basically (1) how much in the rate of change in the physical volume on both imports and exports is related to the current exchange rate levels; and (2) to what extent are we at the margin of capacity with respect both to the existing forecast and to any acceleration in economic growth which would result from a further decline of the exchange rate. I think that that's the crucial question that really [unintelligible] about policy generally. Anyway, I didn't mean to get into this at this stage. Any further questions for Sam?

MR. HOSKINS. It's not really for Sam. It's just an observation. It may be for Ted Truman or Don Kohn. On the question Ed Boehne raised--and you and Jerry also commented on--in respect to using currency market intervention with large open economies, I think that the empirical evidence is that if you sterilize you don't get any effects through intervention over time. I'd be interested in hearing comments on the empirical research because I think the question--

SPEAKER(?). Now, that is a technical kind of question in the sense that if you really do want to alter your monetary policy and use currency markets as a way to do it--that is, to allow money supply to grow or to shrink to match what you are doing--I think that is a different question.

CHAIRMAN GREENSPAN. That's a question of monetary policy.

MR. TRUMAN. Yes, the research has been done--much of it here--and some of it was in the report on intervention that was done multilaterally. The actual report on intervention was done by [the G-7 central banks and finance ministers] and suggested that sterilized intervention may be effective in the short run but was not likely to have lasting effects. We do end up somewhat tied into a semantic problem, in that it's a little hard to say there was \$100 billion or \$150 billion of intervention last year and it had no effect whatsoever. I think that the thrust of the research might say that it had some effect, but it's on the whole--small [unintelligible].

CHAIRMAN GREENSPAN. [Unintelligible] I think the only argument you can make is that sterilizing intervention can have only a short effect and would be meaningful only to the extent that you can alter the psychology of the portfolio adjustment process. And with the huge stock of assets out there, psychology is not an irrelevant consideration because you can get very substantial moves for [unintelligible] period of time with no change in fundamentals, as I would read the same evidence. Long term, there can't be anything there and there isn't. But short term I think it's an ambiguous [unintelligible]--that you can get some temporary effect and if you can do it after an appropriate time it probably can have some [unintelligible]. But I don't know of anyone who can solve the debate on this issue. It has been going on for a long time.

MR. JOHNSON. I think a lot of it depends on which way the fundamentals are taking the exchange rate, too. It's a lot easier to have intervention speed up the adjustment if it's supporting the direction of the fundamentals. If you're trying to fight the fundamentals, I think it's much more difficult--the seventies were a good example of that and, most recently, the last couple of years. It does work even then on the psychology, but it's much more fleeting, I think.

CHAIRMAN GREENSPAN. If there are no further questions for Mr. Cross, can I have a motion to approve the transactions since the last meeting?

SPEAKER(?). I'll move.

CHAIRMAN GREENSPAN. Second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Any objections? Domestic Desk operations, Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Any questions for Mr. Sternlight?

SPEAKER(?). My recollection of the Continental Illinois episode three years ago is that there was a more marked quality spread in the market then than what we see in the First Republic Bank situation. First of all, is that true? And if it is, why? Do you think the market is getting used to this kind of bad news and hardened to it, or what?

MR. STERNLIGHT. It could be something like that. On the attitude toward borrowing, I think that one reason why a big difference didn't show up is that those attitudes were already kind of cautious. Also, there had been a lot of borrowing; there was about one billion dollars of adjustment credit ongoing so that there was a lot of room for those cautious attitudes to show up. But you're right--there was a much more noticeable widening of spreads of bank [unintelligible] and Treasury securities. We've seen rather little of that [this time], and I think that probably does reflect just learning to live with that kind of situation.

MR. JOHNSON(?). Maybe I'm wrong, but it could be, too, that this is viewed as a little more of a regional issue than Continental. If I remember right, there was a lot of concern about Manufacturers Hanover at the same time and there was a great deal of concern that this might spread into the money center banks in general, whereas I think now the basic view is that this is a Texas or Southwest regional problem.

SPEAKER(?). But didn't Europeans hold their paper more than the--

VICE CHAIRMAN CORRIGAN. I think that's a big part of the problem. You don't have that wholesale deposit problem in this case. We have it to some extent, but it's very small compared to what you

had in Continental. I think that in terms of the market's sharp reaction, that put a very different coloration on Continental as opposed to this.

SPEAKER(?). I do think that it might be a bit of a mistake to assume that it's only a regional problem.

MR. JOHNSON. I didn't say that it was. I said that was a perception.

SPEAKER(?). In my own point of view, I think that perception might not be exactly right.

MR. JOHNSON. I can conceive of circumstances in which it wouldn't be.

SPEAKER(?). Maybe there's greater faith that you people can work it out down there, too.

SPEAKER(?). Peter, we talked about seasonal borrowing before, but refresh my memory. At a time that seasonal borrowing is relatively low, as it is now, it will take a higher level of borrowing to accomplish the [unintelligible]. Is there a [unintelligible], say, in December or January?

MR. STERNLIGHT. I would have a little sense of that, yes. And I know that it doesn't show up in all the [unintelligible] that are done. But it does seem to me that, particularly given these low levels of adjustment plus seasonal borrowings, that is a bit of a factor.

CHAIRMAN GREENSPAN. If there are no further questions for Mr. Sternlight, first, we need to ratify his transactions since the February meeting and, secondly, authorize his leeway request. May I have a motion to move?

VICE CHAIRMAN CORRIGAN. I so move.

CHAIRMAN GREENSPAN. No objection? And on the leeway request?

VICE CHAIRMAN CORRIGAN. I move that, too.

CHAIRMAN GREENSPAN. No objection? At our last meeting we had a number of discussions on operating procedures and related issues and a memorandum has been put together by Messrs. Kohn and Sternlight on that. Mr. Kohn would you give a report summary?

MR. KOHN. Thank you, Mr. Chairman. I have only a little to add to the memo. [Statement--see Appendix. The full memorandum, entitled "Issues in the Implementation of Open Market Operations" also is attached.]

CHAIRMAN GREENSPAN. Questions or comments on the issues raised? Peter, did you want to add anything at all?

MR. STERNLIGHT. The only thing that I would do is underscore the point Don made with respect to fed funds compared to borrowing. I

think that they are not so much contrasting positions, but points on a continuum. I think of ourselves now as pretty much back to so-called "normal", but remembering that "normal" does involve close awareness of what's happening with the funds rate. It did before mid-October of last year, and it does now.

MR. JOHNSON. First, I was going to say that I compliment everyone involved in this study for a very careful presentation of the issues. I think it's very well done and balanced. I also compliment the people preparing this for their remark on page four that says: "And it is money market rates, rather than the division of reserves between borrowed and non-borrowed components, that have the most direct impact on other financial variables in markets--such as long-term interest rates, exchange rates, and money growth--through which monetary policy is transmitted to the economy." That's the point that I've been trying to make for a while, because it is the transmission through the funds rate adjustment that is the fundamental feature of monetary policy that we're dealing with here--whether it's the effect on money growth, or other relative interest rates, or whatever. That's the transmission mechanism; it's not borrowed reserves. Borrowed reserves are simply a mechanism by which we adjust the funds rate, and it's as simple as that.

Now, I think there is a legitimate argument for doing it the way we are doing it. I think the point is made in the memo that a borrowed reserve target does allow for some variability in the funds rate and for some market forces to show through. However, my own personal view, and others may differ with it, is that the major reason for variation of the funds rate in pursuing a borrowed reserve target is not market forces--it's basically reserve estimate errors and problems associated with the reserve equation. It is rare for market forces to actually be a major factor in variation of the funds rate, even though you might have some of that show up. In trying to be more sensitive directly to the funds rate as a means of setting monetary policy, you can still allow for those market forces to affect the funds rate. You don't have to go into the market three times a day to adjust the funds rate to keep it within some narrow range. I think that all you have to do is what we are doing now--to some extent, what we were doing for a while earlier--which indicates that you are more sensitive toward the funds rate than the borrowing objective. And you enter the market once a day at the normal time, but your operations are geared toward sensitivity of the funds rate and not toward some borrowing objective which really has no meaning other than to influence the funds rate.

Chart 2 in the paper is a beautiful chart that shows some of the problems with the procedure that we've been following. We had a paper prepared back in July, I believe it was, that was an excellent paper too--it pointed out there was a consistent bias of actual borrowings above expected levels. We didn't know exactly why; we had a number of potential explanations for that. But it's also illustrated in Chart 2. But more important than the upward bias in actual versus expected in that chart, is the fact that I don't agree with the argument in the paper that there are just very short periods of deviation of borrowings from expectations and expected funds rates, because it's clearly not the case. One piece of information that is missing on this chart is how often there were intermeeting conference calls or arrangements with the FOMC that explain the variations from

expectations; I assume the expected line takes that into account. For instance, there's a prolonged period in the spring of 1987--I think everyone here remembers this very distinctly--where you can clearly see in the early months of 1987 this huge spike in adjustment and seasonal borrowing over the expected range. That took place for a two-month period. That wasn't just a short fluctuation in borrowings relative to expectations. That was a huge spike. If I remember, borrowings averaged almost \$800 million during the entire intermeeting period in which the expected borrowing was between \$300 and \$400 million. That's not just a little fluctuation; that is a prolonged period of actual borrowing well above the expected level. You can see the expected level tick up a couple of times there. The only intermeeting conference call took place on April 30th, during which we adjusted the borrowing assumption from \$300 million to \$400 million. But you can see that that doesn't nearly compensate for the actual borrowing. You can go back for a longer period earlier--you can see in the middle of 1986--when borrowings clearly averaged well above expectations for a 4-month period; all of 1985 is another good example. But you can see that on that chart.

So, I think that there is a serious issue of whether we can actually keep borrowings on an expected path. And my problem with that is: What's the point anyway? The only point is to achieve some reasonable range for the funds rate, which represents the transmission mechanism of monetary policy into the economy. So, I think that these charts and the data available here clearly show that there are some problems with this approach. Now, I'm not sure that we have to do something drastically different. I've been very satisfied with the way the operations have been run in the last several months. But I don't see why we can't pursue a procedure more consistent with being sensitive to the funds rate rather than some borrowing objective. It doesn't make any sense to me that we would do otherwise.

The last point I would make on that is that I just can't buy the view that being more sensitive to the funds rate is what got us into trouble in the 1970s. I wasn't here then--maybe some of you were--but from talking to people who were here and trying to study that period, from what I can tell, the mere fact that we were trying to be sensitive to the funds rate wasn't actually the problem. I gather that money growth wasn't all that bad relative to targets during that period. If anything, it had to do with a misunderstanding of money supply measures just like some of the problems that we have now. Also, I think that it had to do with probably a slightly different philosophy. But we're big boys and it's hard to believe that we can't sit here at this table and agree to set monetary policy where it should be, whether it's being sensitive to the funds rate or what. And if we don't buy that, it means that we have to agree to a procedure that tricks us into the right monetary policy. And I just can't buy it.

CHAIRMAN GREENSPAN. Mr. Black.

MR. BLACK. Mr. Chairman, I'm glad that you raised this issue because I share a lot of these frustrations that Manley has voiced. I have thought for some time that we were having a problem with choosing a borrowed reserve level and getting what we wanted in the way of federal funds behavior. A lot of unexpected behavior is short-lived and doesn't really have much impact. But frequently, the deviations

are rather long and rather large; and in effect, I think they end up changing the stance of monetary policy that the Committee wants and misleading the market, too. As Manley stated very well, I think the federal funds rate is the most important thing in determining the demand for money and the behavior of the aggregates over time. And I think that the Committee has been confused by this, because at times we've gotten federal funds rates that were not what we'd expected at all and that has led to some misunderstanding. For example, at the last meeting we had some discussion about what had transpired in the previous meeting.

Now, there are a couple of arguments that have been advanced in favor of borrowed-reserve targeting. The first of these is that you can get movements in anticipation of where we should go that are generated on the part of the market. We've looked at that fairly closely and sometimes this happens; but it just doesn't look to us as if the empirical evidence is really overwhelming on that. You certainly can find a number of instances--Manley cited some, and there are others--where the market has moved the federal funds rate in a way that we didn't want it to move. The Continental situation and right before the October 19th crash, I think, are two notable examples. So, I don't think that argument holds a lot of water. But I think the important argument, and really the reason why we went to this procedure, was basically a political one. We were afraid that we could not move the federal funds rate as much as we really felt we ought to, unless we obfuscated in some way: We're not really moving the federal funds rate, we're targeting reserves and the markets have driven the funds rate up. That may have had some validity at the time, and I had some sympathy for it. But as time goes on, I've become more and more concerned about a procedure that really involves trying to fool the public and the Congress and the markets, and at times fooling ourselves in the process.

What I'd like to suggest, if we have time for it, is an alternative procedure that might conceivably be satisfactory for both sides. The procedure would be to establish a band for the federal funds rate, let's say a weekly average of 50 basis points, that would be understood to be the range in which we would operate during the intermeeting period. The beginning point would be the midpoint of that, but the Desk, in consultation with you, Mr. Chairman, would have the freedom to move anywhere within that 50-point range. This would give us some leeway for market forces to work. And it could be understood that if the federal funds rate moved out of this range, then there would be consultation with the Committee. I think that this would be very clear to all of us and that it would work much better, because now we sometimes get federal funds rates that we didn't vote for and didn't want. So, I think a move in that direction would be very helpful and clearly would be more honest. I would hate to have to defend what we have been doing on the grounds that, in a sense, we really don't want people to know what we are up to. I'd rather stand up, as Manley says, like a man, and do what we have to do. But I do understand the other argument, because in '79, I'm sure we would not have gotten some people to vote for the new procedure if they had not thought that it provided a cover for doing something they didn't think that they could get away with. I've heard members of the Committee state that. So it's not something to disregard lightly; but I think that our long-term credibility can be damaged if we use that as a cover-up for what we're really doing.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Thank you. I also have very much enjoyed reading the papers. But I think there's a semantic unresolved conflict that becomes apparent--in the paper itself, too--that's at the bottom of what both Manley Johnson and President Black have been talking about. For instance, if you look at page four, it is very clearly stated that fluctuations in the funds rate can at times "lead to a misperception of the Federal Reserve's intentions." That's at the top of the page. And on the next page it is argued that "Movements in the federal funds rate can convey information to policy makers about expectations and other aspects of financial market conditions." And then it says a little lower down that "A narrow focus on the funds rate tends to smother such market-generated reactions". Either we see the fed funds rate as a signal to the markets or we see the rate as a signal to us. If we are trying to get both types of signals out of the same number, or we perhaps get the two of them confused, I think that we do have a bit of a problem.

The second point is that I find it very difficult to believe that a \$200 million or \$250 million borrowing target is something that is so precise that we can steer the entire economy with it. It is something that is so minuscule in comparison to the markets that I continue to marvel at the good job that we are doing on it. The seasonal factors and the other things that influence our required reserves are just overwhelmingly large compared to that small number. And then we are arguing here in the Committee about going from \$200 or \$225 million--you know, it's just something so small in the entire economy that I find it difficult to believe that that is really the entire fulcrum on which we can influence what happens in the country at large. There's also the problem that the reluctance to borrow sometimes--I guess you can have the converse as well--would very strongly influence the \$200 million dollar number, as we have seen in the last couple of weeks and months in connection with the Texas situation.

Overall, I must say that I'm very satisfied with what has actually happened. And so I'm torn here. We have a procedure, but I don't really fully understand why it is producing the good results--results that I like. There hasn't been a convincing argument, I think, as to what brings that about. On the other hand, I'm reluctant to say let's get rid of this procedure if it will continue to produce these good results. But I'm not convinced that it will actually do that. Suddenly, we may be off the track and we may be flying that airplane right into the ground. And we'd still be wondering what happened, because we had such a nice borrowing target, but somehow or another the whole growth path of the aggregates isn't doing what we'd like it to do.

Now, there are really two papers in front of us--one by Ms. Meulendyke, in which there is a nice quick discussion of the procedures that existed in the 1970s. It says the FOMC "instructed the Desk to raise the federal funds rate within a limited band if the monetary aggregates were well above the tracking path or lower the funds rate within that band if the aggregates were below the tracking path." It sounds an awful lot like what Mr. Melzer has proposed, except that he was talking about the monetary base instead of the aggregates. But there isn't a lot of discussion about why that

procedure was abandoned. It just says factually that in 1972 modifications were made and, like many of us, I wasn't there. I'd really like to have heard a bit more about why that particular procedure would be an unsatisfactory one. I guess that's perhaps something Mr. Sternlight can enlighten us on.

MR. STERNLIGHT. I don't think there was anything abrupt that happened in 1972. We were getting into closer and closer federal funds targeting that ended rather abruptly in 1979.

MR. HELLER. Because there was a reluctance to adjust in order to--in essence, we were not following this early 1970s procedure the way it was laid out?

MR. STERNLIGHT. Well, I think there was a reluctance to make the moves in the federal funds rate that, in retrospect anyway, would have been a little more appropriate.

MR. HELLER. So, it wasn't a bad procedure, you would argue. It was sort of a lack of moral fiber that--

MR. STERNLIGHT. I'd regard that as an aspect of the procedure that lent itself to that constraint.

MR. PARRY(?). There was the additional problem, too, of knowing what rate to aim at. That isn't obvious. There was a reluctance, I think, in that period, to move the rate sufficiently. And secondly, there was some considerable uncertainty about what would be the appropriate rate if one had the will.

MR. HOSKINS. But if you had had borrowed reserves, there would have been the same question about what the appropriate level of borrowed reserves was.

MR. BLACK. I think that it was the very hot political environment that made us reluctant to do that. You know, interest rates were getting pretty high about that time. There was a lot of pressure on us and we knew that we had to do something. And we had to make it palatable so we didn't get shot out of the water as soon as we began to move. I think--I don't know if others would agree--that's why we did it at that time. I thought that we would end up targeting the money supply; but I think most of the people in the room really thought it was a way that they could get the federal funds rate up more than they otherwise could get away with, in that kind of highly charged political environment. That's the way that I read it. I don't know; Jerry or some of the others who were here might see it somewhat differently.

MR. KOHN. I think it was the case--wasn't it, Peter--that the Committee would come into a meeting and would set a fairly narrow band for the funds rate. And then there was a great deal of dependence on the staff projections for the aggregates--the funds rate could creep in that band if the projections for the aggregates for the next two or three months drifted away from what was desired. But it was a very lagged process and the projections weren't always right. I think that's President Parry's point. It took a long time, given the process, to have adjustments made--with the combination of the narrow band for the funds rate and the projections--

MR. JOHNSON. That's consistent with what I said--I anticipate the problem would be money supply problems.

MR. GUFFEY. There's one other aspect of that: the market understood that we were looking at the funds rate. And a 16th of a percentage point move in the funds rate moved the market at that time. We almost got trapped in our own procedure, in the sense that we had to have a virtual consensus of this Committee and of the then-Chairman to move more than a 16th of a percentage point on the funds rate, simply because the market reacted so violently to it. People such as the Chairman used to interpret that data, I'm sure.

MR. MORRIS. One other aspect is that I don't think we--I was around this place in the 1970s--sufficiently understood that the inflation psychology had become so strong in this country that small moves in interest rates were shrugged off. Moves in interest rates that previously would have had a big impact on the market had no discernable impact at all. And we were very slow to recognize that.

MR. JOHNSON. There were interest ceilings in the banking system; you couldn't even effectively get the rate [up]. Well, I'm not talking about--

SPEAKER(?). What part of the [discussion]--?

CHAIRMAN GREENSPAN. Let's be certain of that. What we're now on is the side issue of the 1979 procedure, which I think is very interesting. Let's continue it, but let's limit it to a certain extent and stay only on the 1979 procedure. I'd appreciate going further. But if anyone else who was here then wants to [comment], that was a terribly important period for exactly this issue, and I don't wish to say that we shouldn't discuss it at all.

VICE CHAIRMAN CORRIGAN. Let me make a couple of general comments. I think that Ann-Marie Meulendyke's memorandum that is attached to Peter's and Don's memorandum is very revealing, because what it says to me is that there's nothing new under the sun--that the same frustrations and the same debate has been going on since time immemorial.

CHAIRMAN GREENSPAN. Are you still on the 1979 issue? Then hold it.

VICE CHAIRMAN CORRIGAN. Okay. I'm sorry.

CHAIRMAN GREENSPAN. Actually, we'll start with 1979. And then I think Governor Angell is next.

MR. HOSKINS. I didn't attend the meetings, but I spent a good portion of my time as director of research [at the Philadelphia Reserve Bank] on the 1979 issue, trying to widen the funds rate bands. We went through a lot of the things that some of us alluded to here when the base argument came up two months or three months ago; we went through things like zone of indifference and zone of tolerance. And during that period--Peter is right--it is part of the process. If you use interest rates, you're going to be procyclical. You may think that you are going to be able to jump out in front, but the experience

was that you just won't move interest rates sufficiently to get on top of an expanding economy.

MR. JOHNSON. I agree. But how is that different from a borrowing target? I'm just saying that the borrowing approach has the same problem with it. If you agree that that was a problem in 1979, a borrowing target would present the exact same problem. So I don't know--

MR. BLACK. I think you can argue that, for some people, it's a little easier to move the borrowing target. I argued as you did. I don't think we ought to do that. But I do think that some people would be more likely to move at the point in the cycle in which we usually make our worst mistakes [unintelligible] cycle.

MR. HOSKINS. I'd do it a bit differently. I think that the borrowing target is more closely related to what I think drives the economy. And it may be that money matters--whether it's the base, M1, M2, or M3--

CHAIRMAN GREENSPAN. [Unintelligible] this is tough to maintain. Maybe we ought to go back to the regular sequence. Governor Angell.

MR. ANGELL. Yes, I'm interested in the discussion. I'm really interested in Governor Heller's point; he made the point that I'd like to make, but on the other side. I'm arguing his side--I think that he's saying that the system really isn't broke and let's not fix it. It's working better than you expected that it would work, or theoretically would work, and that's enough.

It seems to me that we have really three kinds of alternatives: you can target the fed funds rate, and if you choose to do that, we've had experience with that and that can be accomplished; or you can target the money aggregates; or you can target reserves to target money aggregates. I prefer the present position because we, in a sense, are in between. This would permit us, when we believe we can, to emphasize once again the monetary aggregates more forcefully. It seems to me to go in the other direction, and to go back to fed funds targeting, would be seen in the markets as an abandonment of the kind of sound money policies that came out of the policies that resulted in this nation's double-digit inflation rates being brought under control. So it's a very symbolic issue. And the markets, I think, would respond very adversely if we were to move in that direction.

In regard to the political consequences, it seems to me that our experience in 1987--after the October 19th crash and all of these people predicting recession--was that we actually did become very fed funds oriented, and that that was the political incentive. If the fed funds rate didn't respond properly to what we thought was the lowering of the target, then we got all excited. So it seems clear to me that having a fed funds relationship does put you closer to the political situation. I believe that it is so important that money be restricted over a period of time to maintain some scarcity. And this [reserve] pressure approach that we are under is one that enables us to proceed toward a somewhat restrictive monetary aggregate targeting in the future. All of us know that that's important for price level

stability. So I would consider a move to fed funds targeting to be a wrong move and to result in inappropriate policy choices. Now if --

MR. JOHNSON. But how does borrowing do that?

MR. ANGELL. Now, if Governor Heller suggests that \$200 million or \$300 million doesn't make much difference, I ask you: How much difference does it make to change the fed funds rate from 6.75 percent to 6.50 percent? I would suggest that in doing that, we're more tempted to make that move. I would suggest that we would not have made the move we made in February--which I thought at the time was an incorrect move and I still think it was an incorrect move--if we had not been concentrating on the fed funds rate. It was only because we thought that someone might see that very slight change in the fed funds rate that we were encouraged, it seems to me, to accomplish it.

So I would go back, Manley, to the period in 1986 and 1987. I agree with you that we did not strictly follow in an unbiased manner the borrowing targets during that period. It seems to me that we not only had some misses, but there were times that we accepted the actual outcomes that were different. I'm not suggesting a return to that period; I'm suggesting that the Desk follow more closely the adjustment plus seasonal borrowing targets early in the two-week period. We start off following those very closely and we let the fed funds rate move. It seems to me that there's no need on the last day, with contemporaneous reserve accounting, to try to make everything fit and hit the borrowing target on that last day. If we have our average in there early during the two-week period, then I don't mind letting the fed funds constraints be more important on the last day to prevent those spikes. So, I share your frustration concerning the earlier procedures and I don't want to return to them. I really want to follow more precisely adjustment plus seasonal borrowings as an interim policy that will enable us later to return to closer monetary aggregates targeting.

MR. JOHNSON. Then you're arguing for maybe as much fine tuning as several days' changes in the funds rate, in order to stay on some borrowing path continuously through the two-week period. You know, I'm just asking; if everybody wants that, that's fine. I'm just saying, you can look at the evidence and see for yourselves that there are long periods when the FOMC's policy directives have no meaning. And if that's okay with everybody, it's fine with me.

MR. ANGELL. But I think all of us know why that took place; I don't think there's any need for us to go into that. I think we can pursue borrowing targets and have deviations of borrowing around those targets be unbiased.

CHAIRMAN GREENSPAN. Statistically, you can't, because you're dealing with a number which is positive and cannot go below zero. So the bias--especially as you're getting to the lower area--has to be on the plus side.

MR. ANGELL. You mean when you have strong deviations? You have--

CHAIRMAN GREENSPAN. No, I mean the bias. If you're trying to hit a target which can have errors on both sides, it can never have an error which is below zero, so that the expected estimate is always higher than the one you're shooting at.

MR. ANGELL. But that bias is brought in because of the choice of a borrowing target closer to zero. If we would always choose a borrowing target somewhere between \$500 million and \$1 billion, then we would have more leeway to have fluctuations on both sides.

MR. JOHNSON. But what if you don't like the monetary policy that goes with that? What if you don't want--

MR. ANGELL. Well, then you can change the discount rate. If you don't like the monetary policy that goes with \$500 million adjustment plus seasonal borrowing, you lower the discount rate.

MR. JOHNSON. Well, that's the other implicit issue associated with this procedure. It's led almost by discount rate changes--using the discount rate as one of the primary mechanisms of monetary policy.

MR. ANGELL. But you said that we're all strong men and women who can stand up and be counted, and I would suggest to you that there's no better way to stand up and be counted than to change the discount rate.

MR. JOHNSON. If the FOMC doesn't mind being dragged along by the discount rate, that's fine.

MR. ANGELL. I guess it's a surprising development here for the members of the Board of Governors, for the most part, to be arguing that they want the FOMC to have more say, and for the Presidents to be arguing that they want the Board to have more say, which is what's involved.

MR. JOHNSON. I agree that that is what's going on.

MR. HELLER. "After you, fellow", right?

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. As I started to say, I think Ann-Marie's memorandum is interesting because what it says is that there's nothing new under the sun--that this debate, in various forms, has been going on since time immemorial. One of the more revealing things in her memorandum, it seems to me, is that in 1968, as I recall, we established a system of lagged reserve accounting to help us hit a free reserve target; and as soon as we went through all the pain and expense of doing that, we abandoned free reserve targets. What she didn't say, of course, is that in the early 1980s we went to incredible pain and expense to institute a system of contemporaneous reserve accounting to help us set the money supply; and no sooner had we gone through the pain and expense of that we abandoned the money supply targets. Now, if that isn't coming full circle, I don't know what is.

But I think what is at issue here are two things that are inescapable. One is that it's a lot easier to ease monetary policy than it is to tighten. I don't care what indicators you're using; I don't care what your philosophy is; it's a lot easier to go one way than it is the other. And I think that the history of monetary policy around the world is ultimately tied up in that question. I think it's also true, as Manley said, that the borrowings number is obviously a proxy for a bunch of things. But so is the federal funds rate. Indeed, there's nothing particularly appealing about the federal funds rate in itself. You can pick federal funds rates, which at different points in time have been associated with wildly different patterns of economic activity, inflation, and all the rest of it. There is absolutely no magic in the federal funds rate and its relationship to the things that we really care about. The funds rate in its own sense is merely symbolic of a bunch of things. So, whether you're talking borrowings or the funds rate, I think, in some sense, you're talking about a proxy for a collection of things.

And that's partly the answer to Governor Heller's question as to why, if the procedure is so lousy, the results are so good. I think the answer to that is, in part, because we all look through the procedures. In other words, we do not focus simply on the transmission variables or the proxy variables; we look through those things and we make judgments about them based on what we see in the economy, in inflation, and all the rest. Indeed, it seems to me that that's why there are conditional elements in the directive language. That reinforces the view, in my judgment, that the things we are focusing on are imperfect proxies for the things we really care about.

I don't fully agree with the argument that the move away from the federal funds rate was simply a politically driven decision, especially one that was motivated by obfuscation. I think it was more fundamental than that. I think it did reflect the earlier experience. And the experience was, as Frank said, that we were staring a roaring inflation in the face. And we chose [not] to, or were unwilling to, recognize it and respond to it. So, I think there's more to that than politics and obfuscation. I also think that there's more to it in another sense. It seems to me that, regardless of what we use as the proxy for policy, a very crucial question is: What constitutes a change in policy? We are always the ones who will have to answer that question. So, of the decisions that we make, which do we regard as a change in policy? I think we have a responsibility to inform the world when we make a change in policy, as opposed to a little give here and there based on markets and developments and all the rest of that. That's the question that I think is on the table. At the extreme, if you have money supply targets and they're annual and you literally view them as targets, you very seldom change policy. But if you're talking a federal funds rate that is a discrete number--that has a point estimate attached to it--and you really want to say that that's your policy instrument, it seems to me that you are looking at a situation in which you're going to have to be saying with great frequency, Mr. St Germain, we changed policy yesterday.

MR. JOHNSON. But, Jerry, we don't talk about borrowing targets now for the times--

VICE CHAIRMAN CORRIGAN. But again, I think there's a reason for that. And the reason is that they are construed in a way in which

lowering your borrowing target is not viewed as a change in policy. It is viewed as consistent with an ongoing policy.

MR. JOHNSON. Well, I'm not suggesting we announce to the world that we're targeting the funds rate.

VICE CHAIRMAN CORRIGAN. But what are you going to announce?

MR. JOHNSON. We're going to do what we always do. We aren't going to announce to the world today that we target borrowed reserves.

VICE CHAIRMAN CORRIGAN. Again, I just caution you, you get to the point where you still have to answer the question: What is a change in policy? That I think--

MR. JOHNSON. But that's no different than today. What is a change in policy today?

VICE CHAIRMAN CORRIGAN. A change of policy, in the context of existing directives, is an increase or a decrease in the amount of pressure on reserves. And it seems to me--

MR. JOHNSON. But that's all I'm talking about. It's exactly what you do when you alter the funds rate because--

VICE CHAIRMAN CORRIGAN. It's not the same.

MR. JOHNSON. But it is.

VICE CHAIRMAN CORRIGAN. It absolutely is not the same in terms of--

MR. JOHNSON. How is it different?

VICE CHAIRMAN CORRIGAN. It differs in the very sense that we're stuck on this problem right now. Now, when you go back to October, you're trying to hit a federal funds rate target to the second decimal point. And if you're going to do that, it seems to me that that carries with it the implication that policy defined in those terms is going to take on a short-run orientation that is going to be disruptive to markets, more difficult to communicate. If we were to change policy right now, what would you say in your testimony? I saw it on C-Span; you were asked two or three times: Has there been a change in the approach to policy? You said no in your recent testimony. If we literally take the step of saying that we're going to target the federal funds rate, I don't think you can answer that question by saying no.

MR. JOHNSON. The directive would read the same way it does now.

MR. HELLER. Well, you're talking about slightly different things. I think Jerry is talking about getting rid of the monetary growth targets totally, right?

VICE CHAIRMAN CORRIGAN. I'm talk--

MR. HELLER. And you're thinking that, too?

MR. JOHNSON. I wouldn't do that.

MR. HELLER. You're keeping it, right?

VICE CHAIRMAN CORRIGAN. What would you do, I guess is the question?

MR. JOHNSON. I'd do exactly what we do now; the directive would read exactly the same. We'd sit here and vote on a range of federal funds rates instead of a borrowing number or something like that. And we'd do open market operations the same way we do them now.

VICE CHAIRMAN CORRIGAN. But that's a change in the approach to policy.

MR. JOHNSON. The directive would say slightly more, or slightly less, pressure on reserve positions.

CHAIRMAN GREENSPAN. You know, I think the question basically is there is no ambiguity on the issue of targeting some monetary aggregate. They may be right or they may be wrong, but that's clear. And we think we used to know what the relationship was with the economy.

MR. JOHNSON. But we would still be targeting a monetary aggregate.

CHAIRMAN GREENSPAN. I'm trying to get at an interesting issue here, because the question really gets down to how you would determine what the appropriate funds rate is.

MR. JOHNSON. The same way we try to figure out what the appropriate borrowing number is. How do we know what the relationship is between borrowed reserves and monetary aggregates?

VICE CHAIRMAN CORRIGAN. That's what helps us.

CHAIRMAN GREENSPAN. Let's remember why we went to a borrowing target--basically because the monetary aggregates per se sort of broke away from their ties [to broad measures of economic performance] and, as a consequence, required reserves tended not to be working any longer. So, instead of nonborrowed reserves, we just took the top part of it, and knocked out the income velocity part which was giving us trouble, and we now have the borrowing target.

MR. JOHNSON. But what--

MR. HELLER. So you have that little thing that goes up and down. It's like a little boat, and you have enormous waves bobbing it up and down. We don't know; we say as long as we stay two feet above water, we're fine.

CHAIRMAN GREENSPAN. This sounds to me, as Jerry said before, exactly like all of the discussions which led to the targeting of monetary aggregates. Because, in fact, then you had a tie-in.

MR. JOHNSON. But what is this borrowing target? What does it have to do with monetary aggregates? It has nothing to do with them.

VICE CHAIRMAN CORRIGAN. But neither does the federal funds rate.

MR. BOEHNE. It does in this sense, Manley--I think this continuum idea is useful.

MR. JOHNSON. It doesn't have anything to do with monetary aggregates.

MR. BOEHNE. If you think of reserves and the money supply as being a "10" [on a continuum], and you think of the federal funds rate as being a "1", say, the more problems you have with the monetary aggregates through reserve targeting, the more you want to move toward the federal funds rate. And the borrowing is a point along that continuum between total reserves and the federal funds rate. It's not that borrowing per se is important; it's the degree of compromise you make between the federal funds rate and the reserves procedure. And the borrowings thing is skewed in the direction of the federal funds rate.

MR. JOHNSON. I'm simply saying, if you hit your borrowing target precisely--say you hit it on the nose the entire time--what monetary aggregate growth would you get out of that?

MR. ANGELL. Manley, analytically there's no--

MR. JOHNSON. It's totally unpredictable--

MR. ANGELL. There's no disagreement, analytically; you're correct, analytically. It's a question of emphasis; it's a question of stance. Of course, you're going to get the one; you're going to get the other.

MR. JOHNSON. I'd love to be able to narrow this argument from conceptual theoretical issues down to whether we want to use this procedure for various other reasons. That's fine with me. I just want to make sure we understand what--

MR. ANGELL. I think we all do.

MR. JOHNSON. On the theoretical issues of the procedure, I'm not convinced that's the case. It sounds like a lot of confusion to me.

CHAIRMAN GREENSPAN. There is, and I think Frank Morris will add to it!

MR. MORRIS. As I said at the last meeting, I think that what we're really doing under the current procedure is targeting the federal funds rate. The reason is that if you target borrowing, that means that you are automatically supplying nonborrowed reserves to the extent the market demands it. And that means that if the demand for reserves is strong, we'll supply an increased rate of reserve growth in order to have the effect of keeping the federal funds rate from

rising. If the demand for reserves is low, we will reduce the amount of nonborrowed reserves and that will keep the federal funds rate from falling. I didn't mean that we're pegging the funds rate the way we were back in the 1960s and the 1970s. What I think we are doing is keeping the fed funds rate within a certain range. I think that is a desirable thing to do. I don't agree with Bob Black that we should publish a range for the federal funds rate--if he meant that. I think politically we're a lot better off with the present form of the directive, because if we get back to a period where we need to raise interest rates in sizable chunks, we're going to be a lot better off having that form of directive than having to announce a federal funds range of 50 basis points or something like that. On the other hand, I don't think we should kid ourselves about what we're doing. I think there's a good reason for staying with the present procedure, but we should recognize that we're not controlling the rate of growth of reserves--we're controlling the federal funds rate within a band.

So, I think that when we have problems with borrowings--if banks are reluctant to borrow for some reason, or there's some other technical reason why the borrowing is getting out of line with the range of interest rates the Committee is talking about--the range of interest rates ought to be dominant and not the borrowing target. And I think that is precisely what Peter's been doing, and that's why you get these zigs and zags. I think those zigs and zags are very productive and we shouldn't worry about it. It would be a lot less productive if we were getting that kind of movement in the funds rate; if there's some technical reason for it, I'd much rather see it reflected in--

MR. JOHNSON. You're saying zigs and zags in borrowing are productive?

MR. MORRIS. They're more productive than--

MR. JOHNSON. I agree with that.

MR. MORRIS. If we tried to just keep it at a level--

MR. JOHNSON. I agree.

MR. MORRIS. The funds rate would be dropping all over the place.

MR. JOHNSON. I agree with what you're saying.

MR. MORRIS. And I think that would be undesirable. So, I think de facto, controlling the borrowing is a functional equivalent of controlling the fed funds rate. But at the same time I think it would be unwise for political reasons to change the format at this time.

MR. JOHNSON. I'm saying exactly what you're saying, Frank. I'm saying do exactly what you're doing now, except that you avoid the big zigs and zags on borrowings instead of on the funds rate. That's all I'm saying.

MR. MORRIS. I think what we learned in the 1970s--and we should keep it in the back of our minds--is that publishing a funds

range at a time when we need to push the funds rate up would pose a hazardous duty. And we should never get back to doing that.

CHAIRMAN GREENSPAN. I'm sorry, publishing funds?

MR. MORRIS. Publishing in the directive that the Manager should keep the funds rate within a small range. I think it would be unwise for us to go back to that.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, when I heard Bob Heller's remarks, I too was going to say if it ain't broke don't fix it, but somebody already said that. Let me start with a procedural matter. First of all, I thought the memos, particularly the Meulendyke paper, were extremely useful. I wasn't around here in the 1970s and I found that historical perspective very interesting. I would like to suggest that somebody think about publishing that somewhere for the market to look at. Having said that, let me say something nasty now, and that is, that while I enjoyed reading the memo, I didn't have much time to read it because it only reached me yesterday morning. I raise that issue in the context of this discussion only because if we're going to have more frequent consultations, which hasn't been discussed, those consultations frequently will have accompanying memoranda; and if we don't get them in time to really reflect on them, they don't do us much good.

But turning to the substance of the issue, it seems to me as I went through all of this, that I agree with Governor Johnson that there really is very little policy difference between targeting borrowing and targeting a funds rate. I think we really are targeting the federal funds rate, but in a more general way. And I'm persuaded that we should not make a change for three basic reasons, which I think have been touched on by other speakers. First of all, it does seem to me that we get very useful information from the market, because of the deviation in the funds rate in relation to borrowing. Many times those are market induced, and I think policymakers can learn something from what the market is telling us. Secondly, and perhaps more importantly, it seems to me that by using a borrowing target as a proxy for the funds rate--or, if you like, for policy--we're able to probe a little better than we can with a funds rate target. That is to say, the uncertainty generated sometimes by the borrowing and the differential on the funds rate would enable us to reverse policy if we found that that was desirable. With the funds rate targeting, we don't have that kind of flexibility. So, I think we get some flexibility by using a borrowing target.

The political argument has been talked about and I think we ought not to underestimate that, because if we get into a period when we have to tighten policy, it's a very difficult thing to do politically. Some times it's more difficult than others. I don't think that our posture in the past has been to be publicly identified with targeting interest rates--certainly not in recent years. I don't think it's a good idea for us as an institution to have that on our backs. As people look through the realities, obviously they'll see we really are targeting the funds rate; but I think we get some advantage by staying away from the targeting of the funds rate itself. I think you have to be in the market on a regular basis too, Manley; I don't

think you can do it on a haphazard basis. I think you have to be in the market a couple of times a day to really fine tune it.

MR. JOHNSON. You mean borrowing or what?

MR. FORRESTAL. If you were targeting the funds rate.

MR. JOHNSON. The funds rate. Oh, I don't think you need to do anything different than what you're doing now. You'd go in once a day, around 11:40 a.m., but the action the Desk took would be more sensitive towards a rate protest than it would be toward a borrowing protest.

MR. FORRESTAL. But in the--

MR. JOHNSON. That's the only difference that we would pursue. As a matter of fact, we would do exactly what Peter has been doing for the last several weeks. I'm saying I think it has been outstanding.

MR. FORRESTAL. Well, that's the other point I wanted to make. If you find that you are getting major deviations, then I think you can correct that. But I don't think we ought to be doing funds targeting on a regular basis. Now, there are two other things that were said that I think need to be addressed. It doesn't seem to me that we are in any sense misleading the markets by this policy; I don't think it's a deliberate obfuscation. I think the markets understand, and we understand certainly, that monetary policy is not an exact science. And I don't think that using a borrowing target is designed to mislead anybody. Also, I don't think that these deviations--to use the analogy that somebody else did--are causing us to have the airplane on a crash course into the ground. I don't think we're anywhere near that. Nobody has mentioned the intermeeting consultation and discretion, so let me just raise that if it is an issue, Mr. Chairman.

MR. BLACK. I mentioned it.

MR. FORRESTAL. You mentioned it; excuse me, I must have been asleep at that time. I think it's very important for the Manager, in consultation with the Chairman, to have discretion. And I, for one, would not like to limit that discretion with any kind of numerical bounds. One thing I think we could do at regular meetings of the FOMC is to give some sense to the Chairman as to how we feel about deviations from policy or a reversal of policy. But I think that can be done in a general way, without saying if you want to change it \$100 million come to the Committee; I would leave that to the Chairman. But we could have some general discussion as to when we think, in general terms, a consultation is necessary. And finally, I don't think we need any more meetings of the FOMC.

SPEAKER(?). Ever?

MR. FORRESTAL. I don't think the information to be gained, on say, a monthly basis, is sufficient to have us come together to review the situation. So I would like to keep our present meeting schedule, gentlemen.

MR. JOHNSON. I would too, if we're going to do exactly what we've been doing. But I think that's consistent with what I'm arguing.

MR. FORRESTAL. What I'm saying, basically, is just keep what we're doing because, as Bob Heller suggests, maybe we've been lucky. And maybe it won't turn out to be quite as good as it has in the recent past, but I think that's something we just have to accept. I'd be willing to accept those deviations.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, I think just about everything has been said in this conversation. It's a question of emphasizing points. The first point is that we can debate this theoretically, conceptually, now and forever, and it's very frustrating because it involves compromise. We are trying to take two different approaches and compromise them and that's not very satisfying. It seems to me the choice, then, comes down to what works. My own preference would be to get back to where we were before October 19th, which is what I think we have been doing. I don't think we're quite back there, but we're almost there.

I have a couple of reasons for that preference. One is that it does seem to have worked reasonably well. But the point was made earlier that no matter what procedure we have, it's always easy to ease; that's not a problem. We've never had any trouble there. The real day comes when we need to tighten. I'm sure everybody around this table now is much stronger and much more forthright, has more courage and guts than anybody else in the history of the Fed, but I think there are some lessons from history. And the experience has shown that the more you focus on the federal funds rate, the more difficult it is at the time when you need to tighten, to do it. So, I think we need to keep a bit of fuzziness there. I would, on very practical grounds, stay about where we are.

On the other issues: I agree with the point that the Chairman needs some discretion. I have not in any way been upset by the way that discretion has been used. Maybe I would have used it a little differently, but I think on the whole it has been done rather well. And I don't think we ought to hem the Chairman in with numerical kinds of constraints. There is a way, however, that perhaps communication can be sometimes improved. I don't mean to suggest that this needs to be done every time the Chairman uses discretion, but we can have telephone conferences. These conferences do not have to be official meetings; they do not have to be decision-making meetings. They can simply be held to exchange views--a kind of meeting that really never gets on the record if there aren't any decisions made. So, it might be possible, in the right kinds of situations, simply to have these telephone hookups.

CHAIRMAN GREENSPAN. Is that factually correct? Can we have a meeting without being on the record?

VICE CHAIRMAN CORRIGAN. Oh, sure.

MR. BERNARD. Yes.

MR. BOEHNE. If no decisions are made.

MR. KOHN. We have done it both ways, Mr. Chairman. Telephone consultations without votes sometimes are reported and sometimes are not reported. I think more often reported than not.

MR. BERNARD. In the last year or two, yes; but before that, it was the other way.

MR. BOEHNE. Yes, I think over the longer run Norm Bernard is right; we had more that weren't recorded than were. If decisions are made, votes are taken, obviously it has to be recorded. If not, there's some discretion. I agree as well that we don't need any more FOMC meetings, as delightful as these gatherings are.

MR. HELLER. You have the shortest commute.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I see no need at this point to change the current procedures. Harking back to Ed Boehne's analogy of 1 to 10, I thought there were some of us here who would prefer to go back to something like a total reserves target or a nonborrowed reserve target procedure at some point in time. Keeping the framework that's currently in place allows us to keep that hope alive to some extent, whereas if we go straight to explicit funds rate targeting I think we would be doing ourselves a disservice. It's very hard to reverse that process; my experience in the 1970s leads me to believe that. I would stay where we are, in terms of how we're doing this. In terms of the Chairman's discretion, I really don't have too much to say about that; I think he's got to have the ability to make some decisions. And I don't see an easy way to limit that in order to fulfill our responsibilities. I think it's a matter of trust, and I'm comfortable with that.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, if I wasn't confused before this discussion, I guess I would be now. I don't know that I have very much to add. In thinking about the structure of the Bluebook, I guess I'm persuaded that focusing on a borrowing target and focusing on the funds rate basically come out to the same thing. When you read about the policy options [in the Bluebook] they give both the borrowing levels and the interest rate they're consistent with. You can honestly do it either way. Presumably, they pop out of the same kinds of equations. Having said that, I think one of the major reasons this discussion has come up once again is the more fundamental problem that we're all aware of--and we've agonized over for several years now--which is the breakdown of the money/GNP relationship. Without that, we probably wouldn't be going through all this, because we'd be in a more comfortable situation of being able to focus on M1, M2, or something else, and just proceed along those lines.

Having said all that, I guess I do have a preference for continuing to operate the way we were prior to October 19th--which I don't think is very far from the way we've been operating the last few weeks either--simply because I think that, on the margin, there is some value to going through the reserve side of the thought process.

There's an awful lot of volatility out there, and a lot of shocks that hit the financial world and the real economy, and so on and so forth. And it seems to me that we're best advised to try to incorporate as many of those things as possible.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think maybe I ought to clarify some of my statements. I would like to say, first of all, that I'm very sympathetic to what Governor Angell had to say: that what we really ought to do is control the supply of reserves in such a manner that we control whatever monetary aggregate is going to determine the level of prices over the long run. I don't think we can really, in the long run, control real variables; all we can control are nominal ones. I think the objective ought to be stable prices. And that's the way I would want to do it. If we ever get to that millennium, I think that required reserves are probably going to be the best target for us against whatever aggregate we settle on. And I wouldn't want any bands on the federal funds range at all; I would want that to be free to move enough to allow us to hit that target. What I was talking about earlier was this interim period where the demand for money has been unstable and our present procedures call for us to try to gauge the dimensions of the demand for money and set the operating variable that will best give us the kind of results we want. And I think that's the federal funds rate.

So far as this issue of discretion is concerned, I did not mean to take away your flexibility. I was trying to suggest a band that was reasonable--that would be agreeable to the whole Committee as an operating range within which you could adjust the rate. I'd like to use the whole band--that 50-basis-point-average range that I talked about--and just have some understanding that if we went beyond that, you would consult with the Committee. There was some discussion, as you remember, at the last meeting that maybe we shouldn't have changed the borrowed reserve target without consultation. I didn't hold that view, but some did. And I thought it was important that we reach some agreement on when there would be a consultation and that's the reason I suggested it. But, basically, I don't want to do this over the long run with the federal funds rate at all. I want to do it with reserves, somehow measured, if we can get back to a more rational financial [unintelligible]. So, that's where I come out. My recommendation applies only to the interim period that we're in, and if I thought that this would prevent our going back to [reserve targeting]--Lee, as you said--let me change my position.

MR. HOSKINS. Let me say, it has always been different.

MR. BLACK. Let me change my position because I want to get, I think, where you want to get. And if this would jeopardize that, then I've made a bad mistake.

MR. MORRIS. Bob, the interim can turn out to be a long time.

MR. BLACK. I know; traditionally, it has been very long.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor the normal operating procedures, pre-October, without the additional flexibility. The reason I say that is that, in my mind, we've gone as far on this spectrum as we can go toward funds rate targeting. And for a lot of reasons, all of which have been said--political, the relationship of the funds rate to our economic goals, and so forth--I would rather look at our business as being defined in terms of reserves, not interest rates. And frankly, even though it might be perceived by us as a subtle shift, if we begin giving Peter directions in terms of the funds rate, eventually that's going to become known. And I think there's a point of intellectual honesty in terms of communicating that to the public. I don't think we can do that and expect that it will not become known. Then there will be an issue of why this change in procedures wasn't communicated.

The final point I would make--it can be made even with what we're doing now, but even more so if we went to a funds rate target--is that to be consistent with what has been done in the past, we certainly would have to go to a proviso on some aggregate. In other words, you would have to have that balance in there. Just as we now talk about a degree of reserve restraint, subject to fluctuation in the funds rate, if you went to a funds rate, it would have to be subject to some constraint on a narrow aggregate, in my judgment. That's all I have.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I'd like to make a couple of comments as a person who was involved in banking most of the 1970s. The image was that the policymakers just had no courage to fight inflation, because the Phillips curve suggested that when you fight inflation you're going to run unemployment up and policymakers couldn't take that heat. I don't think people were focusing on whether or not fighting inflation by tightening monetary policy meant concentrating on one variable or another. It was a bigger issue: they just thought people who made policy were a bunch of weenies and couldn't handle the big job. That was the view anyway.

I share Manley's frustration with the operation of the Desk at certain points, and I think my frustration reached its peak this time last year. I would just hope that the record of our discussions will really sensitize people to the concerns of some of us that when we think we've voted for a certain policy at an FOMC meeting and then we watch the numbers every day and see that we are getting away from what we thought the Committee voted on--I think maybe this has been a worthwhile exercise. As I said a year ago, we went through a whole month where the daily explanation was that we couldn't predict Treasury balances or one thing or another, and that's why we were getting away from both the borrowing target and where we thought fed funds might be. And then the light dawned: well, in fact, we really snugged a bit. And if that was going to take place--and maybe we needed to snug, by the way--then I think it should have been brought to the attention of the FOMC. I think there should have been a telephone call or something. I agree, certainly, that the Chairman needs discretion; I would argue that with my last breath. But I thought that was a policy change. Also, I'm very concerned about the messages that we send to market participants when we miss, for whatever reason, and when suddenly the fed funds rate runs up--or runs way down, for that matter. I think we could take care of this

situation if we would release the minutes of the FOMC more promptly. That way we would remove all this mystery about what we're doing and they would know. They wouldn't have to dig through all these entrails to try to put together a message. And I think that maybe this minutes policy is something else we could discuss sometime.

I will shut up here by giving an analogy of whether you watch borrowings or fed funds. If you think of yourself as driving an automobile, most of us, I hope, look out the windshield at the road ahead as we're driving along. But we also have rear view mirrors. And I don't want to ride with any of you who just look at either one or the other, because sometimes you have to move the steering wheel to avoid side-swiping when you see the guy coming at you in the rear view mirror. I think the windshield, in this case, would be the borrowing target; but we have to take into account the information we pick up through the rear view mirror which is the behavior of the fed funds rate. And because we don't know these relationships really well, or they change over time, I think we need to be very sensitive to these moves in the fed funds rate. Not that we're targeting a number, because I don't believe in that; but at least we should give attention to it as an indicator of maybe something going wrong in these relationships--whether there's some little change in banker attitudes, or whatever. Maybe this is a cop out by saying we should use some of each, but that's the way I feel.

On the frequency of the meetings, I think that eight a year is just terrific, with the idea being that we can converse in between meetings. We have these nice "lightning rods" they set up on this table and that makes telephone conferencing very easy when there is some policy change that might need to be considered or even a very major change in operations because of an event like last October 19th which, as you will recall, was handled by a whole bunch of daily telephone consultations. So that's my three cents worth.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I agree with a lot that has been said around the table. As a matter of fact, some five or six speakers ago Ed Boehne said almost everything that has been said and I agreed with him there.

MR. BLACK. Is that your entire statement, Roger?

MR. GUFFEY. Just in summary, my view is very much as stated by Frank Morris and Bob Forrestal: that the current procedure of using the borrowing target as a proxy, if you will, for the federal funds rate or for whatever, gives us some latitude in our operations. That seems to me to be desirable at this particular time. And I would strongly oppose moving to simply targeting a federal funds rate, or even a federal funds range, because it seems to me that as soon as the market understands that, then it becomes difficult, or almost impossible, to tighten. You have to keep it a bit fuzzed up to permit the Committee to operate [unintelligible].

Perhaps the issue that is more important is the question of flexibility. And I think the last time I may have made some comments with respect to that and what happened early in February. My view has not changed and I hope I stated it clearly then: I think the Chairman

and the Desk need flexibility. It's clearly an issue in my mind as to what is a policy change and how that should be communicated, either before or after action is taken; and that has to rest largely on the Chairman's judgment. And I'm quite willing to place the responsibility there. When you talk about what is a policy change, I don't think that you can quantify that. I see in the memorandum that was prepared that there's a suggested procedure on page 7: that if the borrowing target is to be moved, the Chairman would have some latitude to change the borrowing target by \$50 million to \$100 million. I don't know, in some circumstances, whether that's really a policy change. But if it were so determined by the Chairman, I would hope that consultation would take place, and take place before the change actually was effected by the Desk.

Lastly, I guess I would ask that there be some change in a procedure that I have observed over a number of years, not just the last 6 months or a year: at times a policy change, perhaps within the scope of the directive, was made within the week before the FOMC met. It was already done before this group gathered around the table. I objected strongly to it then, and I would object strongly in the future. I would hope that if there is a change, that it would be done either around this table or by consultation on the telephone. And I would not be in favor of more meetings in Washington, but it is pretty easy to put together a telephone conference call.

MR. JOHNSON. Let me just suggest, Roger, if you look at chart 2, you're in for a lot of phone calls.

MR. GUFFEY. Well--

MS. SEGER. That's all right.

MR. GUFFEY. I'd rather do it that way.

MR. JOHNSON. Yes, well, that's what I was talking about.

MR. GUFFEY. Yes.

MR. JOHNSON. But that's a lot of phone calls, if you look at that chart.

MR. HELLER. If I look at the chart here correctly, in 1985 there were 10 changes in the borrowing assumption. Were they all phone calls? They weren't all FOMC meetings; were they phone calls?

MR. GUFFEY. In 1985?

MR. HELLER. Yes.

MR. GUFFEY. Some of them were phone calls; and some of them were recorded because there were actually votes taken. Some changes were actually made without telephone calls the week before an FOMC meeting.

MR. HELLER. And they're plotted here as official changes?

MS. SEGER. Yes.

MR. JOHNSON. Yes, everything on that solid line is an official change.

MR. GUFFEY. Everything was--

MR. HELLER. But how can you have an official change without a vote being taken?

MR. JOHNSON. Well, that's what Don said. I asked him; every consultation that was a policy change is on that solid line.

MR. HELLER. Oh, I see.

VICE CHAIRMAN CORRIGAN. Every change in the borrowings level is on that solid line.

MR. KOHN. Yes.

MR. JOHNSON. Yes; that's what a policy change is.

VICE CHAIRMAN CORRIGAN. But not the other--no, that's where I think there's a difference of opinion.

MR. JOHNSON. You're talking about the chart--the top of the chart.

MR. HELLER. Yes.

MR. JOHNSON. Top chart.

MR. HELLER. Yes, the box.

MR. JOHNSON. What is a policy change if it's not a change in borrowing?

VICE CHAIRMAN CORRIGAN. Well, that's the question.

MR. HELLER. And what is plotted here?

VICE CHAIRMAN CORRIGAN. Now, when you look at the rate of [unintelligible]--I think that is the crucial question.

MR. KOHN. Every change in the borrowing assumption.

MR. HELLER. Borrowing assumption by the Committee or by the Desk?

MR. KOHN. Well, the assumption used in constructing the reserve paths. Sometimes these changes were made at Committee meetings; sometimes they were made between Committee meetings.

MR. HELLER. Without a Committee vote?

MR. KOHN. They have been made without a formal Committee vote. That's not for all of them but--

MR. HELLER. No, no, I just--

MR. KOHN. It has happened on occasion; and that's the flexibility that we're discussing.

VICE CHAIRMAN CORRIGAN. That, I think, is the crucial question I was trying to get at before: What is a policy change? I have never felt that every change in the borrowings number in that path has to be considered a policy change. If a change in borrowing is made that is consistent with the way the directive was structured by the Committee, it doesn't follow to me that that is a change in policy. Indeed, that's why I think that it's quite appropriate that that be done by the Chairman.

MR. JOHNSON. Well, that's fine; but Don is suggesting in his paper that \$50 million to \$100 million variation--

MR. KOHN. Well, I think Peter and I had remembered that these are the kinds of changes that had been made between Committee meetings. Let me just add a clarification in response to Governor Heller. There are sentences in the directive which allow these changes to be made; and that was the direction of the Committee.

MR. HELLER. I was just asking for the facts; I wasn't trying to criticize anything. I was just trying to find out the factual information as to whether the line here reflected Committee votes or whatever you actually put into the path.

MR. STERNLIGHT. It reflects what was put in the path.

MR. HELLER. What was actually in the path.

MR. KOHN. That's correct.

VICE CHAIRMAN CORRIGAN. But, again, it seems to me that's the--

MR. HELLER. Well, I was looking at the chart because I thought these were Committee votes.

VICE CHAIRMAN CORRIGAN. And I think it's crucial for you, Mr. Chairman, because as I tried to say before, ultimately the question that is on the table here--aside from the substantive question--is under what conditions do the procedures create a situation in which you are, in effect, required to make a public statement--through a testimony, a speech, or one way or another--that Fed policy has changed. And I don't want to get into a situation in which you have to do that every two months or every two weeks.

CHAIRMAN GREENSPAN. Let me tell you how I would define it. I would define a policy change as one resulting from a change in the economic fundamentals which the FOMC did not perceive, or had not anticipated, and it required some form of adjustment. Incremental changes to fine tune are not policy changes.

VICE CHAIRMAN CORRIGAN. Okay; then, many of these things here would not be policy changes.

CHAIRMAN GREENSPAN. Yes. Don, that's the way I look at it. But, I think it's important for the Committee, not the Chairman, to

define what constitutes a policy change. It's in the discretion of the Committee to set policy. It's in the discretion, as I hear it here, of the Desk in consultation with the Chairman to merely fine tune in that context. But you cannot simultaneously have the Desk or the Chairman define what a change in policy is, because that will of necessity always override the Committee. So, I think what is required is that we get an agreement about what constitutes a change in policy. As I read it, we have a meeting and there's a consensus which emerges with respect to what the outlook is, and that is implicit in the directive. Often the directive is very vague; if somebody were to tell me that that is an extremely sharp [unintelligible] set of instructions, I would tell them I don't understand the language. But what is clear is the preceding discussion about what the general impression is, what various numbers were--[the context] in which we constructed that directive. And they are rather sophisticated insights which are very difficult to put down, but which I think are not unambiguous. I know that if somebody asked me what the FOMC's views were at the last meeting, I'd have no trouble describing them--not in directive terms, but in terms of how the Committee evaluated the economy and the financial system and what it, therefore, thought was an appropriate policy. As best I can see it, when things change such that the Committee's view of the outlook is changing and that therefore alters the structure of the directive--that I would consider a change in policy.

MR. ANGELL. Mr. Chairman, from your perspective did we have a policy change the first of February?

CHAIRMAN GREENSPAN. No, we did not.

MR. ANGELL. Okay; that's what I was assuming--that we didn't. But then, when you went before the Congress, I thought there was an indication that there was a policy change.

CHAIRMAN GREENSPAN. No, I think that was merely an affirmation of what the markets were questioning: whether, in fact, we had nudged down slightly in the funds rate--which we had, by about 1/8th. And the only reason to put that in at the time was not as a statement of policy change, but as an affirmation of what the markets had been discussing.

MR. ANGELL. I think that focuses on the point that if you're looking at adjustment plus seasonal borrowing, then that small change might have been consistent with, what, a \$50 million change?

CHAIRMAN GREENSPAN. A \$50 million change.

MR. ANGELL. A \$50 million change. Clearly, it seems to me, if you make a \$50 million change in borrowing, it's so slight that you wouldn't consider it a policy change and you wouldn't announce it.

CHAIRMAN GREENSPAN. Well, I think the issue is not so much whether it should be announced but whether it should be confirmed or not. The reason I chose to, at the time, was that a lot of people were asking that question, and the simplest way of resolving it--instead of being sphinxlike--was just to admit to it. If it gets to the point that every statement the Chairman makes is a statement of a

change in policy, then we really better think out what the Chairman is supposed to say.

MR. ANGELL. But I think that's Jerry's point: that targeting the fed funds rate may put you in a position of having to make a statement more often than would be the case otherwise. Do we really want that?

MR. JOHNSON. I don't see how that would be the case.

MR. ANGELL. It's because the market was able to discern [a change in the desired funds rate]. Under the adjustment plus seasonal borrowing procedure, the market wouldn't have known, on an 1/8th of a point move.

MR. JOHNSON. But you say that's not a policy change. Why wouldn't it be a policy change?

CHAIRMAN GREENSPAN. It really gets to a question of what the definition of change is, because it is extremely rare that there are big discontinuities involved here. But there's an awful lot of ambiguity about when you go from here to there; it's not a clear cut thing. I must say that before I attended FOMC meetings, I had a different view of what constitutes the nature of policy, because I used to read the directives and I couldn't for the life of me figure out what in the world they were talking about. But now, given the few FOMC meetings I've attended, I'm realizing what it is.

MR. HELLER. But there's a difference between long-run and short-run policy, too. I think Jerry was addressing that earlier. If you're setting your long-run monetary growth targets, and in order not to change your long-run policy you're making a short-term adjustment--let's say in borrowing targets--to get closer to that, you can argue that your long-run policy is unchanged, and therefore, you've got to change your short-term tactics. I think that's where the ambiguity comes in.

VICE CHAIRMAN CORRIGAN. That's part of it. Regardless of what you use as your indicators or your proxies, I think that one way or another we have to try to project an underlying forward looking consistency in policy that ultimately overrides all this noise. Again, as I said before, I think part of the problem is that each of us, in our own way, looks through the noise anyway. Obviously, our judgments about the noise are conditioned by what we see and feel about the economy, inflation and the stuff that really matters. And it's not easy to capture that in the directive either.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. At this point I'm not sure I can handle it! I was intrigued with a line at the end of Ann-Marie Meulendyke's memorandum which says that what apparently started out as a temporary procedure has persisted, with modifications, for over five years. It seems to me that there hasn't been such a significant change of circumstances at this particular time that we ought to make a change [in our procedure.] I'm not persuaded by either the memo or the discussion that we really have a hard basis for making a change. And if we do, I think it ought to be very well grounded. Having said

that, I would have a reluctance to shift to any kind of fed funds rate targeting. We are discussing this at a fairly benign period; the economy is moving along pretty well, inflation is higher than we like but still not out of control, and the interest rate structure is pretty good. But that won't always be the case. As we've said a couple of times, there are going to be some circumstances in which we'll need to tighten. And I think the political pressure would come to bear if we were using the fed funds rate as our focal point--then change would be very tough. I'm reminded of that line: "Don't shoot the piano player, he's all we've got." It seems to me the present procedure has been serving us pretty well; I don't see a reason for making a change.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I'm not a proponent for changing anything we're doing. I'm satisfied with where we are and, therefore, I really have nothing to contribute to this discussion. I assume that nothing's going to change; and if that's so, I'll be satisfied.

SPEAKER(?). Except the discount rate.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, as the one at the table who has the least background in this, I've been enormously instructed by this whole exercise.

MR. BLACK. Say that again.

MR. KELLEY. I don't want to get too explicit about what the instruction was, but I have appreciated it. I came to this discussion without any firm convictions one way or the other, so it has been very interesting for me to listen to the arguments on both sides. Where I'm coming down is to stay where we are, largely on the arguments that surround the flexibility that this procedure gives us. Also, I like the way that market forces have at least an opportunity to show through on this procedure more clearly than they would if we went to the other route. So, I'm comfortable with staying where we are.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I wouldn't change the current operating procedures either. I think the experience with fed funds targeting was not very good and it seems to me that, for the time being, we ought to stick with these procedures. Hopefully, some time in the future we'll be able to move more in a direction of using aggregates. I don't want more meetings.

CHAIRMAN GREENSPAN. It turned out much longer than we had scheduled, but actually it has been an extraordinarily useful meeting. As I read the tone of the proceedings, what comes out is that we probably would like something firmer to target. To somehow get a restoration of the monetary targets and income velocities that look like we could use them, would get us back to the fundamental approach of what monetary policy is all about--namely, interfacing not with interest rates, but with the financial variables in the system which affect inflation and real growth in the real world, rather than the

intermediate proxies that are involved. I sense that there is a general view of satisfaction--that may be too strong of a word--a sense of resignation to current procedures, largely with the assumption that this five-year transition won't last for another five years. And, hopefully, we'll get to something a little firmer to target.

What I would like to suggest, however, is that rather than just allow this issue to fade away, we come back to it again at some point--maybe six months, maybe a year from now. So long as we're in a transition period, I think we should not behave as though it is a permanent, fully satisfactory and solid procedure. I don't think anyone around this table has said that. What I hear is a fairly broad consensus that we stay where we are, but that we continually review it. If there are no objections, I would like to reschedule a review of this in nine months or a year or so, depending on what the circumstances are.

VICE CHAIRMAN CORRIGAN. Do it in December.

MR. ANGELL. So this takes us back to pre-October 19th?

CHAIRMAN GREENSPAN. Yes, we're pretty much back. Since time is running short, I would ask the Vice Chairman whether we could leave the issue of the timing of the organization meeting to the next meeting?

VICE CHAIRMAN CORRIGAN. Sure.

CHAIRMAN GREENSPAN. Because we're not going to be reorganizing again, hopefully, for a while.

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN GREENSPAN. This is probably an appropriate time to break for coffee and we will come back.

[Coffee break]

MR. PRELL. [Statement--see Appendix.]

MR. TRUMAN. [Statement--see Appendix.]

MR. PRELL. Mr. Chairman, I might just apprise the Committee of the data made available this morning. One is the leading indicators series, which shows an increase of .9 percent in February, compared with a 1.1 percent decline the previous month. We also have new home sales which were up 20 percent in February, but to a level that's just around the fourth-quarter average. That's consistent with the other housing data we see.

MR. PARRY. That represented a significant downward revision from January.

MR. PRELL. It wasn't significant, but it was .3.

MR. FORRESTAL. Mike, I heard what you said about inventories, but I guess I am a little confused about the numbers that

are in the Greenbook as compared to the text. The numbers in the Greenbook looked fairly high to me, whereas the text seemed to indicate a slowdown, which I agree with, in inventory buildup. Unless I am misinterpreting the numbers, I would have thought there would have been a greater effect on the economy from that level of inventory buildup.

MR. PRELL. The current number for the fourth quarter on nonfarm inventories is \$57-1/2 billion, at an annual rate. We had \$53-1/2 billion in the Greenbook, which went out before the GNP release. It's not very much different; there's a slightly different level of auto inventories primarily. In our forecast, the rate of inventory accumulation declines by \$20 billion in the first quarter to around \$34-1/2 billion. That is, in a sense, a significant drag on output growth in the first quarter, and it occurred basically in the auto industry. We had, essentially, a \$20 billion dollar swing in the rate of inventory investment in the auto industry and that accounted for something on the order of a percentage point on GNP. But the surprise for us--as the data look at this point, and that's what we're building into our forecast--is that outside of automobiles the rate of inventory accumulation does not seem to have slowed in the first quarter. In the last forecast, I think we put in something on the order of a \$10 billion decline in the rate of non-auto inventory accumulation. So, in that sense, to the extent that businesses weren't as anxious to reduce stocks, you could view that as something of a plus for the economy in the first quarter relative to our expectation.

MR. MORRIS. I think that one of the critical issues for this year is the ability of our manufacturing capacity to deal with the demand that is going to be placed upon it. Looking at your numbers that show only a very modest increase in capacity utilization, is this a consoling factor to you, as far as being able to exert some restraint on the ability of manufacturers to raise prices? Or should I read something else into it?

MR. PRELL. I think we feel we are in a zone where there is considerable uncertainty. The capacity utilization rates are not even across industries. We already have seen price pressures in some industries that we think are a function not just of the dollar decline but of actual pressures on capacity, with a backlog in orders that has built up. There are many manufacturers who have their customers on allocation. They seem to have been rather restrained, to date, in their pricing. In fact, in some cases, they could probably be more aggressive but don't seem to be moving that way because of longer-run considerations, such as their customer relationships and so on. But the kind of increase we've had in capacity utilization doesn't signal to us a major change in that picture. At this point, we think there are risks. If we were to write down a still higher number, our degree of discomfort, or our worry about pressures, could materially change.

MR. MORRIS. Steve McNees reminded me yesterday that the average miss in GNP forecasts made in the first quarter is plus or minus 1-1/2 percent. It seems to me that if we miss on the upside this time, we could have some really serious problems with price pressures in manufacturing.

CHAIRMAN GREENSPAN. He was referring to the run-of-the-mill forecast, not the staff's. [Laughter.]

MR. PRELL. That's a hypothesis I don't want to test!

MR. MORRIS. But it is a sobering number. We don't really have much room. It seems that the forecast you are giving us is 2.7 percent real growth; that's probably as much as we can stand without generating some serious price problems.

MR. PRELL. I think that's what is suggested by our forecast, but there is uncertainty about many elements of this. One is on the labor markets side. As I suggested, our work to date has failed to find convincing evidence that the natural rate of unemployment (NAIRU) is lower than we currently are. The range of our estimates is from around where we are to a higher level. Others have looked at these things differently and have come up with conclusions that may give us a bit more room on the downside. So, for the labor market side, maybe it isn't quite the razor's edge that this kind of forecast suggests. On the capacity side, [unintelligible] just how things turn out in the mix of demands and how rapidly expansion of capacity occurs in the particular industries where demand is strongest. So, I would characterize the picture as being a little mushier than these precise numbers suggest; but we do think that we're pretty close in our bottom line assessment.

VICE CHAIRMAN CORRIGAN. I lost the tail end of your remarks, Ted. You cited a rule of thumb--and I think you said 10 percent--

MR. TRUMAN. In the forecast, where we have a decline in the dollar at an annual rate of a little less than 10 percent occurring smoothly over the forecast period, that's not a big factor, vis-a-vis an absolutely stable dollar, because half of it comes after the first part of 1989. Remember now, inflation is a little higher than it was earlier. With a situation in which you have something like a 10 percent decline in the first quarter of 1988, the rule of thumb--taking into account feedback effects, such as a damping in demand abroad and increased demand here--would say that that would add 2 to 3 percent to the level of goods output in the fourth quarter of next year. Goods output is now running \$1.6 trillion in 1982 dollars. It's a nontrivial amount, but most of it is in 1989. But that's the aggregate amount; it's certainly true that you could well get severe pressures in particular industries.

VICE CHAIRMAN CORRIGAN. Goods output in the context you are using it here--that's something I could roughly associate with industrial production as well?

MR. TRUMAN. Roughly, yes.

CHAIRMAN GREENSPAN. The problem of using that, of the potential inventory change, is it because of consumption goods?

VICE CHAIRMAN CORRIGAN. No.

MR. TRUMAN. It would be investment.

CHAIRMAN GREENSPAN. The GNP [unintelligible].

MR. TRUMAN. Yes. Right.

MR. JOHNSON. I just wanted to ask a question about the models and the natural rate. What do they say about the kind of pressures that develop for wages as you approach the natural rate? I assume you get a lot of wage pressure after you pass the natural rate, but wouldn't you expect a good bit of pressure as you approach it?

MR. PRELL. In the models, it generally would be constructed with some discontinuity on this, so when you get there, then things emerge. But we also know we can't pinpoint it. Looking at different variations on structural models and different estimating periods and so on, we can get a very broad range of estimates.

MR. JOHNSON. I'm just suggesting that if we were, in fact, at the natural rate, you would expect to have seen a lot of compensation pressures as you approached it. The interesting point is that we have not really seen a lot of upward pressure as we reached the 5.7 percent rate. So it could be the capacity level. I think we were starting to see some of those pressures maybe earlier last year before--

MR. PRELL. For last year, it's a matter of interpretation to some degree. To put it in mathematical terms, there are other terms in those equations. One of them would be expectations about prices, and that could have given us the surprise we had last year, as opposed to the natural rate being different than we anticipated in our models. That is something we have taken into account in our forecast, in that individuals may not be setting their expectations as high as the recent inflation experience would suggest is necessary to maintain real wages, because they are fearful about losing their jobs in the very competitive international marketplace particularly.

MR. JOHNSON. But that would suggest a lower natural rate.

MR. PRELL. It could look that way.

MR. JOHNSON. If they are fearful of their jobs in this environment, that means the natural rate is lower.

MR. PRELL. It depends on which terms you want to adjust here, and it's not entirely clear. That's one way. In fact, if you back out the natural rate from our recent experience it suggests that what we built into our forecast--if you take the price expectations being developed in the usual way--could be a natural rate that is around 4 - 4.5 percent. That is the calculation; but we don't really think that the natural rate is that low. So, we think there is something else going on in terms of the expectations of labor and management at this stage [unintelligible] consistent with our forecast.

CHAIRMAN GREENSPAN. One thing we tend to forget is that when a lot of this discussion emerged on resource stringency and the like, we were in the 1950s and 1960s. At that time, we used to think that a big inflationary push was when the inflation rate went from 2-3/4 to 3-1/2 percent. We had some really tight markets in those periods and what we learned, especially in retrospect, was that something happened in the 1970s. It's not strictly the pressure question because we had

much more pressure back in the '60s than now and inflation rates were considerably below where they are now. There was very little inflation premium embodied in long-term interest rates. And yet there was this standard--they didn't call it NAIRU then, but they had this capacity constraint question. There is a tendency in today's environment to take the single points of the 1970s and say inflation pressures mean 3 percentage points, or 4 or 5 points. And I suspect what we are looking at is not this resource allocation pressure but the issue of financial change that has occurred and the money supply and expectations effect that you are referring to. But it may turn out that one fallout from this disinflationary period is that we may have--without our knowing it, and we won't know it until later--successfully lowered the response rate of the NAIRU or the capacity restraint question.

When we look at capacity--and the Fed is the official source of these data--capacity is a very dubious concept. You really don't know whether or not you have run into capacity until you have some objective measures of the inability to meet customer orders. That is really what it's all about. And the lead times on the deliveries on materials--with the exception of steel, [unintelligible] metals products, paper and the like--haven't really expanded all that much. In other words, the system is producing to demand, and even though the backlogs go up, there is no evident pressure. So, while I think we are getting close, and I think the issues we are raising are the correct ones, let's stay with the numbers. And the numbers at this stage are still telling us that there is some flexibility there yet. There may not be much, but I don't see it, and I guess you don't either. It's conceivable that the NAIRU may be lower or that excess capacity in terms of current costs may be still larger in general. I would hate for us to make an assumption and start crying wolf, and then stop crying wolf at the point where the whole thing blows up on us. I think we may have some flexibility here, but not an awful lot. As I see it, the facts don't show anything else. Do you disagree with that view?

MR. PRELL. I guess it's a question of whether the glass is half empty or half full--how much of these price increases you see coming in materials and so on that you view as part of a broader phenomenon or as one-time relative price adjustments. But the list of items that purchasing managers report in short supply has lengthened considerably; and there seem to be lots of reports of supplies being tight and various materials and components [unintelligible].

CHAIRMAN GREENSPAN. It seems that people still report on deliveries in qualitative terms--only relative to something else. When they give you the real numbers [unintelligible].

MR. PRELL. They don't seem to be terribly anxious about getting goods. They're not ordering very much farther in advance than a quarter. So, your bottom line of there being some areas where we should look at this carefully is, I think, [right]. We think things have tightened up, but it's not clear to us that there is imminent danger of broad acceleration.

CHAIRMAN GREENSPAN. We are not getting an inventory rush, which is when things are getting tight, purchasing managers are getting scared, and they really start to load up. They just haven't.

MR. PRELL. What we do see is a mixture of things. We have capacity utilization at the point where product markets have gotten tighter; there is more pricing discretion on the part of many manufacturers. If we do continue to get the effects on import prices from the decline of the dollar, if wages do begin to pick up as a lagged adjustment to the price increases that we have already seen and the lower rate of unemployment, that is an environment where I think pricing could firm considerably.

CHAIRMAN GREENSPAN. I think that is exactly the way to put it. You're in a high risk area, where if anything goes wrong, prices could accelerate. Any other questions before we go to the general go around? We are now open to general discussions. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District economy continues to exhibit strength and we see few signs of weakness. A particularly encouraging sign is the apparent broadening of the expansion throughout the region. States that have had weak or negative growth because of problems in agriculture, mining, and energy are now growing. Manufacturing is enjoying strong growth, especially in export- and resource-related areas. In our view, this expansion does not appear to be threatened by excessive inventories. Our sources generally indicate inventories are at or below desired levels. It appears as though retailers followed a more cautious inventory-stocking policy following the stock market decline in October.

Looking at the national economy, our forecast is for less growth in 1988 than in the Greenbook and about the same growth in 1989. Differences in our forecast center around the size of inventory adjustments and the amount of improvement in net exports. But, it seems to me that the important point is that both forecasts indicate reasonably strong growth this year and next. I feel that both our inflation forecast and that of the Greenbook are very distressing, especially for 1989. It seems to me that the prospect of compensation per hour rising and approaching 5 percent in 1989 is intolerable, if indeed, our objective is to move gradually to price stability.

MR. KEEHN. I certainly agree with the direction of the staff forecast, and I think that from a national perspective the economy really is improving with the passage of time. That is consistent with the conditions in the District which are also improving and I think the improvement is quite broad-based. I commented before on the steel business: it is continuing to operate at a very high level; indeed, those in the Midwest are operating pretty much at capacity. And I am beginning to hear a phrase that I haven't heard in a great many years, namely, "double ordering." People are very much in the business of double ordering for steel; and if they get both, they are pleased to take both because they basically need the steel.

But there are other parts of the manufacturing sector that are showing good improvement. We have been hearing for some months now about the improvement in the machine tools business from various people in the District. Earlier this week we saw some articles on the improvement that is taking place in that industry. Orders for mining equipment and railroad cars are better than they were--showing improvement, albeit from low levels. There are no capacity problems there, but nonetheless the trend is up, not down. And, almost unbelievably, the heavy construction equipment industry has turned

around again, quite significantly, and they are operating at a high level. In farm equipment, last year's big inventories of agricultural implements have largely been worked down, as retail inventories are at a much lower level; and production in that industry is picking up. Mike Prell mentioned that the auto production schedules for the second quarter are higher--some 4 percent higher for the second quarter this year as compared to last year--given higher sales in the first quarter. So I think, as I look across the District, that the fundamental conditions are showing signs of improvement.

The mystery in all of this, at least from my point of view, is the inflation situation. I keep hearing about these big increases in prices--in steel, aluminum, other metals such as nickel, and in paper products and raw materials going into that industry.

who is in the paper industry commented on the very significant price increases that they have experienced on their raw materials. So far it has been at the intermediate level; it hasn't gone through into finished products. But I think there are some margin squeezes out there, and I'm hearing about some anticipated price increases. for example, commented that they have price increases announced for April 1; they're not sure whether the increases are going to stick because their circumstances are pretty competitive. Nonetheless, some price increases in finished products are beginning to move forward. Certainly, that has not shown through in the price indices; and there would be no reason to make a change in policy now based on the indices. While the economic outlook continues to be favorable, and I think we can clearly be pleased with the outlook, there are these upward pressures. And I think the worry has to be on the inflationary side. That is the part of this that we have to be particularly alert to.

MR. BOEHNE. My District continues to be characterized by high levels of activity. The most common comment that one hears is that labor markets are very tight: it's hard to attract unskilled workers; turnover rates tend to be rising; local help-wanted indices are high compared to the nation. When you talk to manufacturers, and some retailers, and even bankers, there is a dichotomy between what they say and what seems to be going on underneath. If you sit around a luncheon table and have an informal discussion, you would think that we were heading into a depression and things were terrible, in terms of the general conversation. But then when you ask them what they are doing, what their orders are, what their plans are, whether they are hiring people, whether they are expanding, you get a wholly different picture. I find this dichotomy in their minds about what's going on to be fascinating.

On the national economy, it seems to me we are in a period of evolving risks: in November-December, the risks were on the side of not enough growth; the last time we met, I think the risks were about evenly balanced; and at this meeting, I think the risks have shifted more toward the inflation side. That's all I have, Mr. Chairman.

MR. FORRESTAL. The better-than-average growth that we have seen around the country is also reflected in the Sixth District. We have seen a remarkable resurgence in manufacturing over the past several months, but with some slowdown in retail trade, services, and housing, which I guess is pretty much the same around the country. I was interested, Mr. Chairman, in your comments about capacity

utilization because, while the evidence that I have heard from people around my District confirms a lot of what you said, there are some industries, as you indicated, that are reporting difficulties in filling orders. In the paper, paperboard, and steel industries, the time frame I hear is 5-6 weeks; but interestingly, in the paper and apparel industries, I'm hearing reports that some of this ordering may be precautionary because of concerns about capacity utilization. Maybe that is equivalent to the double ordering that Si Keehn talked about. I think a lot of people still have some skepticism about the value of the dollar remaining where it is and the sustainability of the tradable goods sector. But even with that skepticism, I think the very high capacity utilization in some industries is now causing people to take another look at the business investment situation. In fact, some are doing more business fixed investment than I had been aware of before. Associated with that, I guess, business loans around the District are up, on average. The thing that I hear talked about more than anything else these days is price pressures. There is some concern about inflation in the labor market in the District and just a general fear of inflation, which isn't really reflected in the numbers that people give you. But there is this general sense that they are concerned about it. Overall, in the District, our growth has been somewhat stronger than the nation and we think that it's going to retain that edge in 1988.

Now with respect to the national economy, our outlook for real GNP is about the same as the Greenbook; ours is just a little lower--2.5 percent as opposed to your 2.7 percent. But the composition is really quite different. We show substantially less inventory accumulation, with the offset in higher personal consumption expenditures, particularly after the 1st quarter, and also more business fixed investment. Our outlook for inflation is generally the same as the Board staff's. I remain concerned not only about import prices, but also about pressures building in the labor market, which I've heard about in the District. We haven't seen any dramatic breakout in labor costs but I think the potential is there. The last time we met I guess I felt that the risks to the economy were fairly evenly balanced, but I was more concerned about the downside than the upside. I've changed my mind now and I think that we face the possibility of too much growth rather than too little at this time, especially given the small amount of slack in major industries.

MR. BOYKIN. Mr. Chairman, on the national economy, we would line up pretty well with the Greenbook forecast. We've felt for the last several months that on the national level we [unintelligible] fairly good performance. Looking at the District level, and I guess more particularly at Texas, about the only bright spot that we can find is in manufacturing, where we are seeing improvement. We're having employment in the manufacturing area as great as, if not greater than, other parts of the country; and of course, the services industries related to that are doing well. Having said that, I've said about all of the good that I can. The overall unemployment rate in Texas, for example, is well over 8 percent, which is considerably above the national rate. Agriculture did have a good year; it is hoped that it will have another one. I think drought conditions might be developing and are causing us to wonder slightly about that.

Obviously, one of the major things going on down our way is the bank and financial conditions, which I understand we will get into

later in some detail. But it's a very, very heavy overhang in terms of attitudes and willingness to take on new ventures. There's certainly concern over the ability to obtain financing from financial institutions in the local area. The real estate situation obviously has contributed very significantly to these problems and there is no short-term solution to that. It's going to be more long-term, as opposed to immediate, as far as what's going to be happening in Texas. I think it's going to be a very close race between the ability of our local financial institutions and businesses to improve their balance sheets and get a little sounder footing and the onset of a downturn in the national economy at some point. If we do encounter such a downturn before we are able to position ourselves a little better, we are going to have even bigger problems than we already have.

MR. MELZER. I want to comment on a particular area of activity: commercial construction. We had a group in recently and a couple of things came out of the discussion that really surprised me, in terms of psychology. St. Louis and the District in general have lagged the national economy in this area. We have not had the overbuilding that occurred elsewhere, so I don't know if these observations are broadly applicable. We kicked off the discussion by talking about the external adjustment process and what the implications of that were for savings and investments--to see whether these real estate people were seeing any pressures on the financing side. And what we heard is that they are literally awash with money--foreign money, insurance company money, [unintelligible] October 19. Nobody mentioned that there was a flow of monies into real estate because of inflationary expectations. The other thing that we did not pick up in this discussion, which surprised me, was any sense of caution about the ability to build space, lease it up, and so forth. Well, I shouldn't say that--there was one person who was somewhat cautious. But the general mood was ostensible optimism. Finally, I was surprised at what I heard on the inflationary front: people on the building side said that they could still build things for what it cost them four years ago. I asked specifically about steel. Two people said that the one area where they picked up some sense of price pressure was on the operating side--that it was difficult to make the kind of margins they would like to make. So, I relate that discussion.

I also have some observations about what is going on with the takeover and LBO activity and so on. Last night we met with an investment manager who was saying that junk bond spreads to Treasuries are as narrow as they have ever been historically, and the GIC market is very tight just because there isn't enough high yield product out there to satisfy the demand. And I think to myself, here we are three, four months or so after October 19 and there is all this leveraging and speculative activity going on at a time when, frankly, I would like to see a little more caution.

I think we are all comforted that consumer confidence has held up. But at the moment there is a lot of liquidity out there. I'm not saying that we provided it; I don't mean to suggest that we have been pumping in a lot of reserves. But, if you look at the construction industry on the inflation front, it's kind of a tinder box waiting to go off. If the inflationary psychology tips there, and that gets factored into interest rates, people will try to move very quickly to lock in financing and begin building before the inflation

hits. I think it could create a surge in spending. I am somewhat concerned about that aspect, and as I say, just in general about the speculative activity--the highly leveraged type of activity--that resumed so quickly after October 19.

MR. BLACK. I think these upward revisions that the staff has made are perfectly appropriate, Mr. Chairman, in light of the data we have gotten since the last meeting. I keep thinking about a remark someone made then about how nice it would be if we could hold onto these things--the low unemployment and the rate of growth for the sixth and now the seventh year of expansion--still without much pickup in prices. I'd buy that scenario any time and I guess a lot of other people would too. I suppose some people might think that this is a rather rosy scenario, but I really think the danger lies on the other side: that we may get too much strength in the economy, more than we now anticipate, and this might stimulate a sharp increase in inflationary expectations with the predictable fallouts on the dollar and U.S. interest rates. And I believe that that is a risk we can do something about with monetary policy. I think we ought to be concerned about it, and in that connection, I would be getting a little concerned about the strength in the aggregates. I would really be concerned if that continues for another month or so in the face of apparent strength in the economy. I am not yet suggesting that the aggregates have gotten to the point where we ought to place as much emphasis on them as we did a few years ago, but I think they now may be giving us better information about the economy than they were a while back. I think it would be wise to pay a little more attention to them than to try to appraise the strength of the business outlook as we have been doing the last several months.

MR. STERN. As far as the economy of the District is concerned, the expansion is continuing at a modest pace, and is reasonably broad-based by now. I, too, have heard a few scattered reports about double ordering, and I don't think there is any question that, at least at current exchange rates, a lot of businesses in our District certainly can compete with foreign producers and foreign products.

As far as the national outlook is concerned, I have changed my forecast pretty much as the staff has changed theirs in the Greenbook. I have been surprised by the tenor of the incoming data on the national economy, which is generally better than I had expected. I think that does call for revising up the near-term forecast. What it says about the longer-term prospect for real growth, I am not altogether sure, but it makes me marginally more confident about the outlook. As several people already have commented, the really striking feature about the outlook--both the one presented in the Greenbook and the one that we have developed [at our Bank]--is the acceleration of inflation that seems to be in prospect. Obviously, there is a lot of uncertainty surrounding that, as there always is. And the acceleration is not dramatic, but I certainly find it troubling. I think that perhaps that is the key aspect at this point.

MR. HOSKINS. The Fourth District is pretty much as I reported last time. Manufacturing activity is very strong. We have several firms, primarily in primary metals, that have reported that they are at capacity levels; they simply can't produce anything else. One of those firms is considering some kind of expansion at this

point, because they believe the demand is going to last a lot longer than they had anticipated before. That is primarily because of the client involved. We see a reaching of capacity limits now across a broad spectrum of manufacturing activities, from glass through chemicals, at least with the firms within our District. Not everybody, though, is planning to move ahead to build plants or expand capacity; there are still a lot of people who are not quite ready to take that step.

In terms of price increases, you heard me say last time that, at least at a couple of firms, primary metals--steel principally--have risen 15 percent or so. I have not heard of any new price increases since then, but that is coming out of the gate at the start of the year with a pretty hefty price increase. We are getting the same thing in chemical products now: 10 to 15 percent price increases. But they have not shown up in the national indices.

In terms of the overall outlook for the country, we are very similar to the staff in terms of real growth. The composition is somewhat different: we actually have stronger PCE--as we've had for the last six months, probably--and weaker net exports. I have some concerns if you're right on exports and we're wrong. But if we're right on PCE and you are wrong, we have a problem. Given the potential for that problem, I see a resource-constraint type of problem; trying to make room to ship goods abroad with our resources requires a slowdown in the expansion of consumption. If we don't get that, then I think we are going to get the inflation forecast that my own staff is turning out, which is very similar to yours. And frankly, I find the CPI [projection] of 5 percent in the second half of the year a very distressing number to have to face, when I think that our objective, as I stated before, ought to be price stability--and by that I mean zero.

MR. GUFFEY. Mr. Chairman, we also have revised up our forecast, particularly for the first quarter, but we still don't come to as strong a forecast for the year as a whole as the Board staff does; we're roughly one percent less than that. We have not quite as much growth in the first quarter and substantially less in the second quarter; the third and fourth quarters look about the same. The difference largely, as has been mentioned already, is in the projection for inventories. We would see the growth of inventories to be somewhat less than in the Board staff's forecast. I assume the underlying assumption of the Board staff is that the buildup in the fourth quarter largely was voluntary and will continue at fairly high levels in the period ahead. We would think that is not the case, and as a result, that is the difference in the forecast.

With respect to the Tenth District, there has not been a great deal of change from what was reported last month. I will just go through the various activities. Agriculture has had a very good year, largely because of government transfer payments, but also because red meat prices, principally cattle, have been very good. Export-related activities have picked up; there is some hope that perhaps in 1988 the government subsidy that goes with that will, in a sense, continue to permit agricultural products to be shipped abroad. With regard to energy, what had looked at the end of 1987 to be a bit of a recovery, particularly in terms of exploration, has turned back around because of the instability of energy prices. For example, in

December there were 363 rigs working in the Tenth District; in January that fell to 307, and in February it fell to 271. It's simply a matter of the instability in those prices. People are not willing to put their money out to put a hole in the ground and hope that there's something at the bottom of it. If some stability comes through OPEC pricing, then I think that very quickly they will be back to exploration in our area. With regard to commercial real estate, it's flat in most areas with the exception of Omaha and Kansas City. But it's overbuilt in Denver, Oklahoma City, and Tulsa; and as a result, as Bob Boykin has mentioned, that is a long-term workout problem that probably isn't going to get any better in 1988.

With regard to the overall tenor, it seems to me that from discussions I've had with people in agriculture and manufacturing and retail business, their feeling is that things are indeed better. They would expect 1988 to be better. There seems to be no constraint on input goods; there doesn't seem to be any upward pressure on prices. I would add an observation on the earlier discussion about the natural rate of unemployment. It seems to me that because of what we have been through since 1979 and into the early 1980s, there may be a lag after you reach that natural rate before prices really begin to rise. Then people realize it and are willing to take the chance of raising prices, and you get the explosion in prices that I think the Chairman mentioned. I think we are on very dangerous ground at the moment with regard to the level of unemployment--whether it's at the natural rate or not I don't know. I think you can go for a quarter or so beyond the natural rate before you get that explosion in prices, but I think the danger is on that side.

MR. ANGELL. It seems to me that our economy has some very bright spots in it. I am not quite as concerned as others that we are going to move from somewhat slow growth to very, very robust growth. Even though I had a forecast of 3 percent real growth fourth quarter to fourth quarter at the February FOMC meeting, there are still some areas in our economy that have weakness. It is my belief that price pressures may not come because of output pressures but because of some of the developing notions about our policy response in a period in which the foreign exchange value of the dollar could come under serious attack. It seems to me that commodity prices, which at best are mixed, have never really had the fallback that generally is accompanied by their leveling off. Some commodity prices have moved up and some have moved down, and I suppose, on aggregation they seem not to be posing a tremendous problem. But it seems to me that they are high enough to motivate a lot of productive activity and a lot of capital goods orders, so that the producer durable goods orders could very well be higher in the second half than we have projected.

I also share the view of Bob Parry and about five or six others of you about the inflation forecast for 1989. Frankly, I am not as complacent as I would like to be in that regard. In the past I felt that we have been overpredicting the rate of inflation a little; yet it seems to me that we are now at a crucial point where price rises could become rampant and could explode. That's why I am worried about the broader aggregates growing at almost double-digit rates in January, February, and March. Knowing, as we found out last fall, that it takes quite a bit of time before changed opportunity costs of holding money seem to affect the growth of those aggregates, it seems to me that we are in a precarious position here where we could have a

breakout on the price side that would be most unfortunate. So I, for one, believe I would like to join the 4-3-2-1 club. That is to say: How in the world can any of us be policymakers and not want to get the rate of inflation, as Lee Hoskins says, down to a zero rate? If we are going to get it down, we really have to begin. And it seems to me that 5 percent doesn't do it; it needs to go the other way. My preference would be to start with four percent on the CPI in 1987, be down in the 3 percent range in 1988, and proceed lower [thereafter]. But I would invite anyone to join the club who would have a different timetable; I wouldn't care if you wanted to start in 1988 rather than in 1987. But for those who really care about price level stability, I would think that we have to make some changes at this point.

MR. HELLER. I think I would agree with the pretty satisfactory description of the overall economic growth picture, of unemployment, and the good investment outlook as well. Some people have pointed to some weakness. And, while we are making enormous strides in the external sector, let's remind ourselves that we still have a long way to go there. Therefore, we can't let the domestic boomlet get totally out of hand, because we have to shift resources to the export sector in the years to come to get that external imbalance removed. On inflation, there is one number that nobody has really talked about much--I'm glad I was able to look over Mike Kelley's shoulder and take it away from him--

MR. KELLEY. You are, but go ahead. [Laughter.]

MR. HELLER. The Producer Price Index hasn't moved at all for the last half year, and I think it's important to keep it that way. The price pressures that others here have been talking about are certainly there--for example, in the metals sector. Monetary growth is higher than we have targeted and the dollar is under pressure. So, while I am very satisfied with the overall operation of the real economy, I think it is important to keep it that way.

MS. SEGER. I have just a couple of comments, primarily based on some conversations I had with people in the auto industry Friday and yesterday. As I looked at the general statistics, I thought the consumer looked as if he or she was pretty tight-fisted. Certainly, the retail sales look that way; the consumption numbers for the last five or six months have looked that way, I believe. People point to auto sales as some sort of exception, but at least the people I spoke with in the auto industry are not putting that kind of interpretation on this. What they are saying is that they had to put incentives on 75 to 80 percent of their lines because they were sitting on this tremendous inventory, the dealers were squawking, and they had to help move the inventory out. In connection with all this effort, they actually reduced inventories by 58,000 units between the end of January and the end of February. We seasonally adjust and we multiply everything by twelve. The dealers who are holding the inventories are paying interest on actual numbers; they don't get seasonally adjusted. Anyway, there is this feeling that they have to move these things and that there is a big advantage these days to keeping your production lines running because your workers are happier and your suppliers are happier. The auto industry has excess capacity these days, and therefore, the pressure is really on them to do everything possible to move these units. I sense that there is real fear about what might happen if and when they remove some of these incentives; they don't

seem too eager to test the market real soon. In connection with this, the production schedules are looked at each week. They did announce some higher schedule amounts for the second quarter. They look at these on an ongoing basis, though, so they are not stuck with the higher numbers if they don't believe the numbers are consistent with the sales results. Also, in the context of the room in this economy for producing for export, when you nail down some of the numbers, it makes me think that we have more room than some people realize. For example, one automaker is talking about a big increase in export opportunities for a certain make that we export to Europe: 400 units this year and 1200 next year. That's a mammoth percentage increase; I can't do it in my head. But, in fact, getting 400 units this year and 1200 next year on the kind of base that they're talking about here is not going to cramp anybody's style or their production facilities. Finally, I checked with two of the big three automakers on the price pressure issue and said "I'm reading all this stuff in the paper; what's really going on?" One of them, who had just talked to their purchasing agents last week, said that in terms of what they are actually paying, they're not seeing this. I think the difference is that we are confusing what is happening to some of the list prices and what sharp purchasers are paying.

My final point is this: let's say the price of copper rises by a nickel. That is a tiny percentage of the total cost of a lot of products. There are all sorts of things that we [consumers] pay for, like utility bills and labor and so forth; so I think you have to keep this in some sort of perspective before you assume that the increase in copper prices will be approximately the increase in the CPI. I am still not convinced that we are about to go lickety split at 90 miles an hour. I hope you can convince me that there is more strength there than I am able to find so far.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I don't have much to add. Our forecast is virtually identical to the staff's forecast. I think that the amount of room on the upside is just about zero. In other words, any acceleration of growth from these forecasts carries with it rapidly escalating risks that the inflation problem will begin to show through again. The problem with inflation is that if it starts to show through, it could build quite rapidly. On the other hand, if GNP growth were even a percentage point or so slower than forecasted for a quarter or two, especially if that slower growth were in domestic demand, I have to say that it isn't going to hurt my feelings terribly. As I said earlier, I do view the exchange rate situation with some renewed anxiety. It's not that I care about one exchange rate versus another, but right now I see clear risks on the downside with very little to be gained. To me, it's a question of risks versus rewards and I don't see much there on the reward side at all.

I also have a lot of sympathy with the point that Tom Melzer made about the return of the wild, wild West to the financial scene. I, too, find it frankly astonishing that some of the things have reappeared as fast as they have, coming off the events of October. I don't know what we do about that. I guess the answer probably is, nothing. But it clearly does bring with it some long-term problems of a potentially serious nature. Hopefully, we won't have a recession in the foreseeable future, but we will at some point. I don't know if it

will be 1999 or 1989, but there will be a recession. And when that recession comes, the potential consequences of it--in a context in which the system is progressively more and more leveraged and basic tenets of financial discipline don't seem able to stick--are very, very distressing. I don't think there is anything we can do about that at the moment, but it is a big concern.

MR. KELLEY. Mr. Chairman, there seems to be heavy sentiment around the table that the risks are increasing on the upside and I share that. But I feel constrained to make a couple of points in the other direction. I think we should keep in mind, going back to what Frank said earlier this morning, that GNP forecasts are subject to a plus or minus 1-1/2 percentage point error. He was concerned about the plus 1-1/2, but let's not completely forget the fact that the minus 1-1/2 is a potential also. And there are a number of things out there that could point toward weakness: some of the rates of increase are slowing down; industrial production and retail sales are not exciting; you have potentially serious financial conditions in the Southwest. I'm not 100 percent convinced that we are out of the woods with regard to the lagged effects of the slow growth of the monetary aggregates in 1987. Capital expenditures look like they are going to be up, but new orders are down right now. So, there is some cause to keep our eyes open, looking in the rear view mirror if you will, looking at the downside.

In the area of inflation, if I may quote you from this morning, Mr. Chairman, let's stay with the numbers. Bob Heller was looking at how inflation has been flowing in the last few months. If you look at the PPI particularly, but also the CPI, on a month-to-month basis against the same month a year ago, both of the indexes have fallen every month for the last six months--and that includes February, the latest figures. So, while inflation certainly has the potential to rise--I see that the same as everybody else here--it absolutely is not here yet. And I don't think it is unreasonable to expect, particularly with a 4.8 percent fourth-quarter GNP, that if inflation were going to show up, it would have begun to do so by now. So that makes me wonder if we aren't looking at some things that could be fundamentally different in that area than we're used to. I don't know that I believe that, or that it is true, but one begins to wonder. In short, Mr. Chairman, I think there is concern about the possible downside risks and perhaps some time to take continuing readings on the inflation side; so, I would be somewhat slow to jump on the assumption that things are going to get away from us on the upside.

MR. MORRIS. Mr. Chairman, as I indicated earlier, I'm still concerned about the potential for the economy overheating this year, particularly in the manufacturing sector. I think later on this year we are going to be running pretty thin margins in a lot of manufacturing industries, in terms of capacity utilization. And one thing we have learned from the 1970s experience is that if we are going to stabilize the economy and prevent inflation from blowing up again, we have to be willing to act before it is clear that inflationary pressures are here. If we wait until we see wages escalating or prices escalating on a broad scale, we will have a momentum that is going to be very difficult to turn around. And I think we ought to keep that in mind when we rule on a policy today.

MR. JOHNSON. I think that just about everything has been said. I second what Frank Morris just said: that if we are going to keep inflation under control, we're in a situation that requires taking some risk with policy ahead of the ball game, rather than waiting until the pressures start to show up. I think everybody has already said what is obvious to me, too: that the economy is doing better than most people would have thought after the stock market crash and that there probably are some significant risks that things could pick up and we would be close to some sort of inflation threshold. I think those risks are there.

However, we have seen since the stock market crash some pretty good improvements in the inflationary-expectation environment, although most recently we've seen some trends back the other way. I don't know whether what we have seen over the last couple of weeks is simply a washing out of the recession forecast out of the market. I tend to think that is what we are seeing. Analysts and traders are looking at the situation now and are just scratching the recession forecast from their outlook, and the financial markets are reflecting that some. But we have had, after all the major improvements in financial conditions since the stock market decline, some trend back toward firming up. Long-term Treasury yields have gone up about 50 basis points relative to the funds rate, and some additional downward pressure on the dollar is starting to develop. Commodities are sort of a mixed picture: some are strengthening and some are not; oil prices are jumping around; the broader indexes are sort of flat, but some narrower measures of commodity prices are showing strength. I don't really know what to make of this--whether everybody's breathing a sigh of relief that we're not heading for a recession or whether this is the beginning of some pressures that we need to worry about. One thing that is clear to me, though, is that the stock market does not appear to be settled. I think last week was a pretty harrowing experience again with the stock market losing 100 points. So, I still don't get the impression that things are back to normal in the financial markets.

I think that tells me that we're sort of on a knife edge, policy-wise. We can make the mistake on the downside or the upside here. But we have to take some risk. My personal view is that there may be more upside risk, in terms of the beginnings of some pressures indicated by conditions in the financial markets and in the other real economic data. But I think we ought to be very cautious at this point, because there are downside risks, as has been pointed out. I think the stock market is very uneasy about the situation.

CHAIRMAN GREENSPAN. It's getting to be 1:15. I suspect that it would be appropriate, rather than to try to finish up, to continue the meeting over lunch and truncate, to a certain extent at least, our regular luncheon agenda. So, why don't we take a break now to get lunch and then we will continue the FOMC meeting.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Do you have any analysis of how the staff interest rate forecast affects the thrifts and the Texas situation?

MR. KOHN. Not to my knowledge.

MR. PRELL. Well, I guess we have the usual forecast. We think that thrift earnings might be cyclical [unintelligible]--I'm sorry, I just don't have that.

MR. ANGELL. I believe that forecast would [unintelligible] one large thrift almost \$1 billion.

MR. PARRY. I've seen some sensitivity tests for and if you have interest rates go up a full percentage point, it would accelerate their losses substantially.

MR. ANGELL. Bob, you and I are talking about the same institution.

MR. PARRY. All right.

CHAIRMAN GREENSPAN. Questions for Mr. Kohn? If not, shall we do our usual circle?

MR. HELLER. Let me just ask a quick question, which has to do with the same problem I was talking about before. We have fed funds rates still at fairly high limits. I'm not talking about current policy now, but what if you wanted to have a fed funds rate around 3 or 4 percent? If we're close to that [unintelligible] barrier, as far as the borrowing is concerned, what's going to do it?

SPEAKER(?). Discount rate.

MR. KOHN. Yes. I think the obvious answer was just given, which was to reduce the discount rate.

MR. HELLER. Yes.

MR. KOHN. Although there's a footnote in the Bluebook that we did run for fairly long periods of three or four or five months in late 1982 and early 1983 with funds right around the discount rate. We have run also for a shorter period of time with the funds rate below the discount rate--in the credit control period in the spring of 1980, for example. But you'd probably have to pay a lot more attention to what the funds rate was doing; you couldn't do it off of the borrowing function once we got down to that--

MR. JOHNSON. You could just target the funds rate below the discount rate.

MR. HELLER. Well, yes. But I always--

MR. ANGELL. And that's fairly easy to do. All you do is just let people borrow from the discount window without asking a lot of questions on whether they have collateral.

VICE CHAIRMAN CORRIGAN. Do what?

MR. KOHN. It has to be working off the excess reserve part of the demands for reserves. I think it would be very sensitive to small misses in factor projections and things like that.

MR. KEEHN. Don, back on seasonal borrowings--a question related to what I asked Peter at the outset this morning. Doesn't a \$200 million borrowing level, now that seasonal borrowing is going up, really represent, in a slight sense at least, an easing of policy?

MR. KOHN. I guess ordinarily. President Keehn, my answer would be no. Almost all of our statistical econometric work suggests that those seasonal movements in borrowing don't get reflected in the funds rate. But I would say that at these levels of borrowing, where we're down close to frictional levels and seasonal is such a high proportion on the adjustment side, I would have more questions. I think it could well be that if seasonal borrowings were to rise, even at \$200 million, this would have some effect on the funds rate. And that's one reason why I suggested that if that seemed to be happening that would be one reason for Peter to make non-policy adjustments in the borrowing assumption over the intermeeting period if the Committee wanted to allow it.

CHAIRMAN GREENSPAN. President Parry has the floor.

MR. PARRY. Mr. Chairman, it seems to me that two significant developments have occurred since our last meeting that have a bearing on this policy discussion. First, economic activity is stronger, and prospects are that growth will be more robust between now and the end of 1989 than was anticipated in mid-February. Second, since the growth is occurring with the economy operating in an area close to full employment, the prospects for inflation have worsened. Most disturbing to me is the possibility that increases in labor costs will be rising at more rapid rates. Such a development would be a major setback to our inflation--

[Secretary's note: The transcript ends at this point owing to a malfunction of the recording equipment.]